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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1124

SOUTHWESTERN LIFE INSURANCE COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Southwestern Life Insurance Company, the Petitioner herein, petitions for a Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit which reversed, in part, and remanded the judgment of the United States District Court for the Northern District of Texas.

OPINIONS BELOW

This case originally involved several issues, only one of which Petitioner seeks review. The opinions of the courts

below are printed in a separate Appendix volume. The full decision of the Fifth Circuit is reported at 560 F.2d 627 (1977). It is reprinted in the Appendix (App. pp. A-1 to A-53). The decision of the Fifth Circuit relating to the issue here involved is reported at 560 F.2d 637 to 639 (App. pp. A-25 to A-31). The full opinion of the United States District Court for the Northern District of Texas is not officially reported. It is reported at 75-1 CCH U.S.T.C. ¶9321 (1975), and is reprinted in the Appendix (App. pp. B-1 to B-54). That portion of the District Court's opinion that relates to the issue here presented is reprinted in the Appendix (App. pp. B-19-22; 43-44). The Order of the Fifth Circuit denying Petitioner's petition for rehearing is set forth in the Appendix (App. p. C-1).

JURISDICTION

The decision of the Fifth Circuit was entered on October 5, 1977. A Petition for Rehearing was timely filed by Southwestern Life Insurance Company, which Petition was denied on December 2, 1977.

The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Section 804 of the Internal Revenue Code of 1954, as amended,[1] excludes from a life insurance company's taxable investment income that portion of such investment income which is attributable to and held for the purpose of meeting the policy and other contract requirements of the company. The investment income held for the policyholders of a life insurance company is, in general, determined by multiplying

[1] Hereinafter referred to as the "Code".

each item of investment income by a fraction, the numerator of which is the contract liability requirements of the policyholders and the denominator of which is the total net investment income. Section 805 of the Code defines the numerator of this fraction, *i.e.*, policy and other contract liability requirements, to include, *inter alia*, "interest paid". Further defining "interest paid", Section 805(e)(2) provides that "interest paid" shall include ". . . amounts in the nature of interest whether or not guaranteed, for the taxable year on insurance or annuity contracts. . . which do not involve, at the time of accrual, life, health, or accident contingencies."

The primary question is whether the District Court was correct in holding that amounts paid or credited by Petitioner as "excess interest" with respect to pension funds which it administers constitute "amounts in the nature of interest" and, therefore, are to be excluded from Petitioner's taxable investment income; or whether, as the Court of Appeals held, the pension contracts involve "life, health, or accident contingencies," and, therefore, the "excess interest" is to be included in Petitioner's taxable investment income, notwithstanding these amounts are, in fact, paid or credited to third party pension funds.

2. In the alternative, the question is whether the pension fund contracts which Petitioner administers in fact involve life, health, or accident contingencies at the time the excess interest is accrued. The District Court made no findings of fact or conclusions of law with respect to this question in view of its interpretation of Section 805(e)(2). The Court of Appeals did not address itself to this question.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.) Section 805(e):

> (e) INTEREST PAID. — For purposes of this part, the interest paid for any taxable year is the sum of —

(1) INTEREST ON INDEBTEDNESS. — All interest for the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from taxation under this chapter.

(2) AMOUNTS IN THE NATURE OF INTEREST. — All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.

(3) DISCOUNT ON PREPAID PREMIUMS. — All amounts accrued for the taxable year for discounts in the nature of interest, whether or not guaranteed, on premiums or other consideration paid in advance on insurance or annuity contracts.

(4) INTEREST ON CERTAIN SPECIAL CONTINGENCY RESERVES. — Interest for the taxable year on special contingency reserves under contracts of group term life insurance or group health and accident insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.: Section 1.805-8. Interest Paid):

(a) *In general.* Section 805(e) provides four categories of interest items the sum of which constitutes the "interest paid" for any taxable year. Interest paid is

one of the elements of the policy and other contract liability requirements of a life insurance company. The amount of the policy and other contract liability requirements is used in determining the policyholders' share of each and every item of investment yield which is not included in taxable investment income. See section 804(a) and §1.804-2. Interest paid includes interest on indebtedness, discounts on prepaid premiums, and interest on insurance or annuity contracts for which no provision is made in the life insurance reserves. Interest paid does not include dividends to policyholders (as defined in section 811(a) and paragraph (a) of §1.811-2) or amounts derived from mortality savings or expense savings. In computing the interest paid for any taxable year the same item may not be included more than once.

(b) *Interest paid defined.* For purposes of part I, subchapter L, Chapter 1 of the Code, the term "interest paid" as used in section 805(e) means the sum of —

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(2) All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve at the time of accrual, life, health, or accident contingencies. Amounts in the nature of interest do not include amounts derived from or representing mortality gains, expense savings, underwriting profits, or other items not in the nature of interest. Amounts in the nature of interest include so-called excess-interest dividends as well as guaranteed interest accrued within the taxable year on such contracts. A contract to pay insurance benefits in

installments over a specified period, for example, a contract to pay the insurance benefit in 10 annual installments, is considered as a supplementary contract not involving life contingencies. It is immaterial whether the optional mode of settlement specified in the insurance or annuity contract arises from an option exercised by the insured during his or her lifetime or from an option exercised by either the insured or a beneficiary after the policy matured. Thus, no distinction is made based on the person choosing the method of payment, and the full amount of the interest accrued, and not merely the guaranteed interest, is considered as interest paid. Amounts in the nature of interest include interest on dividends left on deposit with the company and interest on premiums paid in advance.

STATEMENT

Petitioner is a life insurance company organized in 1903 under the laws of the State of Texas, with its principal place of business in Dallas, Texas. As such, it is under the control and supervision of the State Board of Insurance of Texas. Petitioner, for each year 1958 through 1965, timely filed its Federal income tax return on Form 1120L and paid the amount of tax liability shown to be due. (App. pp. B-1, B-2.) Petitioner is engaged in issuing multiple forms of life and accident insurance, including individual and group life insurance policies, individual and group annuity contracts, individual and group accident and health contracts, term life insurance contracts, and annuity and life insurance contracts designed specifically for qualified pension and profit sharing plans (within the meaning of Section 401(a) of the Code).

Based on 1976 data, Petitioner was the twelfth largest stock life insurance company by total assets in the United States and was the second largest in the State of Texas.

During the years in question, 1958 through 1965, Petitioner issued four basic forms of insurance contracts to qualified pension plans: (a) pension trust annuity contracts, (b) group permanent annuity contracts, (c) pension trust life contracts, and (d) group permanent life contracts.[2] Under the laws of the State of Texas, Petitioner could not guarantee more than 3.5 percent interest on pension plan reserves. (App. pp. B-20, B-22.) Therefore, in order to be competitive with bank trust departments and other savings institutions for private pension plan funds, Petitioner agreed to pay its pension plan customers amounts in excess of the interest rates which could be guaranteed in the reserves pursuant to Texas law. Since interest rates on current investments ordinarily were and still are in excess of the 3.5 percent, Petitioner agreed to pay such pension trust funds "excess interest" in accordance with its fixed predetermined formula. This formula, generally termed the "new money rate" formula, operates in the following manner:

(a) Petitioner measures the investment income in terms of a percentage rate of return on new funds

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[2] The difference between the pension trust annuity contracts and the group permanent annuity contracts which Petitioner issues is primarily one of mechanics. They both provide the same premium rate in relationship to benefits, although the group permanent annuity contracts have a smaller aggregate premium solely by the expense saving in issuing only one master group policy. Similarly, the same distinction exists between the pension trust life contracts and the group permanent life contracts. The basic difference between the annuity and life contracts is that the latter provides a death benefit greater than the cash value from the date of issue to the date when reserves equal or exceed the death benefit. This equalization normally occurs at approximately age 58.

invested by it during a current year. This percentage rate is referred to as the new money interest factor.

(b) Petitioner reduces the new money interest factor by 1/2 of 1% as a management fee.

(c) The new money interest factor (after reduction for management fee) is then reduced by the amount of guaranteed interest in the policy to arrive at the excess interest rate, which is then multiplied by the current mean reserves of the policies still in force; this is the amount of excess interest.

(d) From the amount of excess interest, there is subtracted $100 plus 5¢ for each policy in force as a calculation fee; the net amount constitutes the amount which is actually paid or credited by Petitioner on the pension plans which it administers.[3]

The base of Petitioner's excess interest formula is derived solely from its investment earnings, and the formula does not involve or consider any elements of mortality gain, expense savings or underwriting profits. (App. p. B-22.)

On all of the pension contracts upon which excess interest is paid, Petitioner establishes an initial premium at date of issue. The rate is predetermined and precalculated. Generally, this premium guarantees that at age 65, the plan participant will have an annuity which will provide him a specified amount per month for life (or other optional monthly benefits). In addition, at retirement, the Petitioner contractually offers the participant the annuity guaranteed

[3] The net result of this formula is expressed in terms of dollars. However, it will hereinafter be expressed as a percent and termed the "adjusted new money rate".

from the date of issue of the contract or the right to purchase another annuity which could then be purchased with the cash value, whichever will produce the higher monthly benefit. At retirement age, normally 65, there is a life contingency in the event that the pension plan participant elects to take his benefits other than in a lump sum, *i.e.*, an annuity benefit payable for life only, ten years certain and life, or a joint and survivor annuity. During the accumulation period on the *annuity* contracts from date of issue to retirement date, the death benefit is equal or equivalent to the surrender value of the contract. The surrender value of the contract in turn is equal to the reserves.[4] With respect to the pension trust annuity contracts and the group permanent annuity contracts, there is no life contingency from the date of issue through the retirement date. The only life or mortality contingency involved is that, when the participant reaches age 65 or retirement age, such participant may elect a life annuity involving a mortality risk, instead of the surrender benefit. The initial premium calculation assumes that such contingency will occur.

During the accumulation period of the pension trust *life* contracts and the group permanent *life* contracts, a death benefit would be paid over and above the surrender value of the annuity contract only in the event the participant died before the reserve equaled or exceeded the death benefit. Ordinarily, this "cross-over" point would occur approximately seven to eight years before retirement age or age 65.

[4] This will not be true for approximately the first two years because of the "loading" factor, primarily attributable to agents' commissions. However, the NAIC and the State Insurance Departments do not describe this small disparity as a "life contingency". Neither, apparently, does the Government.

An example[5] may simplify and more sharply focus upon the issue in this case. Assume the following:

Mean Pension Plan Reserves	$1,000,000.00
Guaranteed or "Maximum Legal" Interest Rate	3.5%
Current Earnings Rate on Total Investments of the Company	4.0%
Credited to Pension Plan Funds (Adjusted New Money Rate).....	5.5%
Gross New Money Rate	6.5%

Applying the above assumptions to Petitioner's question here involved, Petitioner issues pension fund contracts under which it guarantees a rate of 3.5 percent. The gross new money rate under the above-described formula is 6.5 percent, and the adjusted new money rate is 5.5 percent. The "excess interest" would be the difference between the guaranteed rate of 3.5% and the adjusted new money rate of 5.5%, or an additional 2% of the mean reserves, which is $20,000.00.

For Federal income tax purposes, Petitioner, in computing the amount of exclusion of investment income attributable to policyholders, properly used the current earnings rate (4% in the above example) times the mean pension plan reserves, (Section 805(a)(2) of the Code.) In addition, it excluded the "excess interest" of 2% in the above example as "amounts in the nature of interest" within the meaning of Section 805(e)(2). Upon examination, the Internal Revenue Service disallowed as an element in the exclusion numerator for policy and other contract requirements the "excess interest" (2%). It did not disallow, and there is no controversy with

[5] In the interest of simplicity, Petitioner will use this example throughout this Petition. This example accurately develops the issue involved in this case.

respect to Petitioner's entitlement to utilize, the current earnings rate (4%) in determining the net investment income attributable to the policyholders as the "current earnings rate" on pension plan reserves in accordance with Section 805(a)(2) of the Code. For Federal income tax purposes, the guaranteed maximum legal rate of 3.5% insofar as pension plan earnings are concerned has no independent significance.

The District Court held that the amounts paid or credited by Petitioner as excess interest (2%) to its pension plans constitute "amounts in the nature of interest" within the meaning of Section 805(e)(2) of the Code, thereby excluding such amount from Petitioner's taxable investment income. (App. p. B-44.) In effect, the District Court held that it was simply not Petitioner's "income" but "income" that belonged to the pension trust. The Court of Appeals reversed, holding, in substance, that for the "excess interest" to be excludable as "amounts in the nature of interest", it must be paid or credited on contracts which do not involve life, health or accident contingencies. (App. p. A-31.) Neither the Court of Appeals nor the District Court addressed themselves to the facts underlying the question of whether, *at the time of accrual* of the excess interest, the pension contracts involved, life, health, or accident contingencies. The total amount of the excess interest paid by Petitioner in the years 1958 through 1965 and which the Internal Revenue Service disallowed as an exclusion from Petitioner's income as amounts in the nature of interest was $3,477,871.90. More than 65% of the excess interest amounts was credited to these pension plans at a time when, under Petitioner's view, the annuity or life contracts did not involve life, health or accident contingencies.

All reserve requirements for the annuity contracts and life contracts are computed at the time the policies are issued,

and the reserves for these contracts at the time they are computed involve life, health and accident contingencies. The District Court in this case so found (see App. p. B-44), and the Court of Appeals did not dispute this finding. In the broad sense, the Court of Appeals, however, held that the "excess interest" paid by Petitioner was the income of Petitioner and not that of the policyholders, even though Petitioner had paid or credited such amount of "excess interest" to its policyholders.

REASONS FOR GRANTING THE WRIT

1. The question of "whose income is it" is at the very heart of this issue. If the "excess interest" is the policyholders' income, it should not be subject to taxation to Petitioner. Under the taxing formula developed by Congress in The Life Insurance Company Income Tax Act of 1959,[6] there is a fundamental premise that income attributable to or set aside for policyholders is the policyholders' income and should not, therefore, be taxed to the life insurance company. One item of income that is attributable to policyholders under the statute is "amounts in the nature of interest" as set forth in Section 805(e)(2) of the Code.

This Court recently considered a corollary question under the 1959 Act of "whose reserves are they." *United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 97 S.Ct. 430 (1977). The specific question there involved an interpretation of Section 801 in determining whether an insurance company qualified as a "life" insurance company for Federal income tax purposes. In turn, the answer to the qualification question depended upon whether the reserves were

[6] P.L. 86-69, 73 Stat. 112. Although titled the "Life Insurance Company Income Tax Act of 1959", the first year that the Act was effective was 1958, not 1959. References to such Act will be termed the "1959 Act".

attributable to the reinsurer or the reinsured, *i.e.*, "whose reserves are they." Although this Court in that case was presented with a different technical issue than the issue here involved, the fundamental policy question is the same.

The premise that a tax should not be levied on the net investment income that is attributable to meet obligations to policyholders with respect to a life insurance company was first contained in the Revenue Act of 1921. It was carried forward in subsequent acts dealing with life insurance company taxation, although various formulae were used in computing the amount of the reserve deduction which is attributable to policyholders of a life insurance company.[7] In connection with the 1959 Act, the House, in its version, continued this concept of a *deduction* from a life insurance company's investment income to meet policyholder requirements. However, the Senate developed the expanded concept that the life insurance company and its policyholders were basically two partners who shared items of investment income and expense. The share or amount belonging to the policyholders is to be *excluded* from the company's tax base and, therefore, not subject to tax. The House receded in conference and Congress, in the 1959 Act, adopted the *exclusion* concept.[8]

[7] Revenue Act of 1921, c. 136, Sections 242-247, 42 Stat. 261-264; Revenue Act of 1924, c. 234, Section 245(a), 43 Stat. 289-290; Revenue Act of 1926, c. 27, Section 245(a), 44 Stat. 47-48; Revenue Act of 1928, c. 852, Section 203(a), 45 Stat. 842-844; Revenue Act of 1932, c. 209, Section 203(a), 47 Stat. 224-225; Revenue Act of 1936, c. 690, Section 203(a), 49 Stat. 1710-1711; Revenue Act of 1938, c. 289, Section 203(a), 52 Stat. 523-524; Internal Revenue Code of 1939, Section 203(a), 26 U.S.C. (1952) ed.) 203(a).

[8] This Court, in *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 85 S.Ct. 1379 (1965), stated:

> "Under the 1959 Act the undivided part of a life insurance company's assets represented by its reserves is considered as a fund held for the benefit of the policyholders." 381 U.S. at 239.

Therefore, in approaching a proper statutory interpretation of Section 805(e)(2), the fundamental question of "whose income is it" must precede analysis of the grammatical construction contained in such section.[9] With respect to the "excess interest" paid or credited by Petitioner to its policyholders, the Court of Appeals held, in effect, that even though these amounts legally belonged to the policyholders, they were nevertheless taxable to Petitioner. This answer is in direct contradiction to the underlying thesis of the 1959 Act. The "excess interest" was paid or credited to the policyholders. Therefore, assuming that more than one interpretation of Section 805(e)(2) can be made, the interpretation should be made that accords with the fundamental policy of Congress. This question is of sufficient importance to merit this Court's consideration and ruling on the clear underlying Congressional intent and the apparent contradictory result of the Court of Appeals.

2. Using the example set forth on p. 10, *supra*, if a bank held pension plan reserves of $1,000,000 and credited an adjusted new money rate of 5.5% ($55,000) on these reserves, the bank would get a deduction (exclusion) of $55,000 in

[9]This Court has considered the fundamental concept of "whose income is it" in various contexts. For example, an oil and gas royalty owner's share of production is *excluded* from the working interest owner's share of production, even though they both have an economic interest in the same reservoir. See *Anderson v. Helvering*, 310 U.S. 404, 60 S.Ct. 952 (1940). A person who attempts to assign income to another is still taxable on it. *Helvering v. Horst*, 311 U.S. 112, 61 S.Ct. 144 (1940). Insurance income is properly realized by a related life insurance company, not by a bank which controlled the insurance company. *Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394, 92 S.Ct. 1085 (1972). Contributions to a retirement plan by a health plan foundation were currently taxed to the partnership that provided the services. *United States v. Bayse*, 410 U.S. 441, 93 S.Ct. 1080 (1973).

computing its tax liability; hence, it would owe no tax with respect to the pension funds it administers. On the other hand, if a life insurance company (Petitioner) held the same reserves and credited the same adjusted new money rate on these reserves, under the Court of Appeals decision it would only be entitled to exclude 4% or $40,000 based on its current earnings rate. That would leave $15,000 on which the life insurance company would be taxable even though it, like the bank, paid or credited the entire $55,000 to the pension plan. Assuming a 48% corporate tax rate, the life insurance company would pay tax of $7,200 versus the bank's zero on the same amount paid or credited to the pension plans.

While it is impossible to determine the total impact of this disparity of treatment on the life insurance industry, it is estimated that the amount of private pension reserves held by all United States life insurance companies was approximately $88,400,000,000 as of December 31, 1976. Of this total amount of reserves, it is estimated that $30,000,000,000 could relate to "active life" pension reserves which could involve excess interest.[10] By relating the $15,000 of additional income, upon which the life insurance company would be taxed in the above example as compared to a bank, and the $1,000,000 of pension plan reserves used in that example to the $30,000,000,000 of pension plan reserves (1.5%), the result of upholding the decision of the Court of Appeals is estimated to have an adverse economic impact (giving effect to Federal income taxes at a corporate rate of 48%) of .72% of those private pension reserves held by life insurance companies. This translates into an additional

[10]Statistics published by the American Council of Life Insurance for 1976 indicate private pension plan reserves totalled $88,400,000,000. *Life Insurance Fact Book '77*, p. 40. This amount is then reduced for separate account reserves and policies which do not appear to generate excess interest.

annual tax charge to the life insurance industry over other financial institutions which handle such pension funds that could exceed $200,000,000.

Notwithstanding the fiscal importance to the Treasury of this amount, of overriding importance is the expressed Congressional intent to aid small businesses to establish exempt qualified pension plans. The Senate Finance Committee Report[11] clearly states this policy:

> "In determining the share of the investment income to be attributed to the policyholders and, therefore, not subject to taxation with respect to the life insurance company, one element taken into account under both your Committee's Bill and in the Bill as passed by the House is the investment income earned in connection with reserves accumulated for qualified employer pension and profit sharing plans. In determining this element, which is not to be taken into account in determining the tax base of a life insurance company, both versions of the Bill provide that an amount is to be attributed to the policyholders equal to the current earnings of the company on its book reserves held for qualified pension and profit sharing plans. To the extent that the insurance company holds additional amounts of surplus to cover its contingencies under these qualified plans, the investment income on the surplus will be subject to tax at corporate rates in the hands of the company. This will also be true to the extent that such income enters into the underwriting income tax base and is not paid out in the form of policyholder dividends. Likewise, a tax will still be imposed at the company level to the extent of any capital gain tax attributable to this income.

[11] Sen. Fin. Comm. Rep. No. 291, 86th Cong., First Sess., pp. 7-8.

> This favorable treatment for qualified pension and profit sharing business is believed desirable in view of the fact that investment earnings of a qualified pension or profit sharing trust are completely exempt from tax while they are accumulated in the trust. Generally speaking, it is the smaller employers who are forced to set up insured pension plans rather than trusteed pension plans because of the greater risk and higher ratio of expense connected with the operation of a small trust. A higher tax on similar earnings in the hands of insurance companies than is provided in the case of trusteed plans therefore is generally discriminatory against small businesses. This accounts for the treatment provided by both the House Bill and your Committee's Bill . . . ."

This $200,000,000 detriment to insurance companies as contrasted with other financial institutions is contrary to what Congress intended in attempting to create a competitive climate between banks and insurance companies for the private pension plans of small businesses.

On this basis, the industry will be forced either to stop writing such "excess interest" business because it generates an economic loss, or reduce the amount of "excess interest" it will pay to take into account the adverse tax effect. The end result is, or course, that small businesses will suffer because their choice will be to set up either more expensive non-insurance company trusteed plans or accept a lower return from insurance companies, a result completely divergent from what Congress intended in enacting the 1959 Act.

In view of the potential and substantial economic loss to the life insurance industry and in view of the certain

litigation to be spawned by this issue,[12] this Court should hear and resolve this question and establish a national solution for the benefit of not only the life insurance industry and the Government alike, but also for many small businesses which place pension funds with life insurance companies and are entitled to expect the best rate of return on their invested premiums.

3. The Court of Appeals seemed greatly influenced by the assertion that to sustain Petitioner's interpretation would:

> "... in effect, give a double benefit to the taxpayer because the excess earnings on its reserves, as we have already pointed out, have already been included in the numerator of the fraction because *all* of the company's earnings on reserves, including the excess over the 3½% rate, have been included in the term 'the adjusted life insurance reserves'." (App. p. A-28.)

This statement is not correct. The only interest rate which has been included in computing the Petitioner's "adjusted life insurance reserves", *i.e.*, pension plan reserves, is the current earnings rate as provided by Section 805(a)(2) (4% in the example). Therefore, if Petitioner's view is sustained, only

[12] One can easily envision litigation reaching the proportion that the "deferred and uncollected" premium issue reached since 1958. This Court finally resolved that issue only last year in *Commissioner v. Standard Life & Accident Ins. Co.*, ... U.S. .... , 97 S.Ct. 2523 (1977). It is equally significant to observe that this Court has heard only three cases involving issues under the 1959 Act. *United States v. Atlas Life Ins. Co., supra; United States v. Consumer Life Ins. Co., supra* (three consolidated cases) and *Commissioner v. Standard Life & Accident Ins. Co., supra.* The life insurance industry, involving more than 1750 companies in the United States, has a substantial effect on the economy. Resolution of issues and certainty of questions of taxation are in the public interest.

the excess of the current earnings rate over the maximum statutory interest rate on reserves (.5% in the example), would be included in the numerator twice. Using the 1976 industry figures on p. 15, *supra*, this excess for the life insurance industry could approximate $72,000,000,[13] but this result is solely a function of the taxing formula provided in the 1959 Act. Moreover, if because of a declining economy, the current earnings rate falls below the guaranteed interest by the same amount as the current earnings rate exceeds the guaranteed rate (*i.e.*, .5%), the insurance industry would suffer an economic tax loss equal to $72,000,000. Thus, the insurance industry may benefit or may suffer from this provision. As stated in the Senate Finance Committee reports (*supra*, note 11 at 5):

> "Your committee concluded, after considering the matter very carefully, that it was not desirable to make use of the assumed rates, either the company's own individual rate or the industry average, in determining the policyholder's share of investment income."

Therefore, this Court should hear this case in order to correct the Court of Appeals in its assumption that to sustain Petitioner's position would result in a double tax benefit to the extent of *all* the excess interest. The fact is that Congress intended to apply the formula approach which goes further than state law allowances in the amount of investment income that is attributable to pension plan reserve earnings.

4. The 1959 Act (Sections 801-820 of the Code) provides a three phase procedure for the taxation of life insurance

[13] This amount is derived as follows: Current earnings rate (4%) — maximum statutory rate (3.5%) = .5% x 48% tax rate x 30,000,000,000 pension plan reserves = $72,000,000.

companies. The primary categories of income subject to tax are "taxable investment income" (as defined in Section 804), "gain from operations" (as defined in Section 809) and the "deferred portion" of underwriting income that is not taxed until such income is made available to shareholders. (Section 815) See *United States v. Atlas Life Ins. Co., supra,* Note 2.

The primary question in this case is whether the "excess interest" paid by Petitioner pursuant to its pension plan contracts is investment income attributable to the policyholders or whether, notwithstanding the fact that it is paid or credited to third party pension plans, it is part of the Company's taxable investment income. This question in turn depends upon the answer to whether these "excess interest" payments are "amounts in the nature of interest" within the meaning of Section 805(e)(2).

The determination of policyholder's share of investment income that is not taxed to the insurance company is generally determined by multiplying each item of investment yield (income) by a fraction, the numerator of which is "policy and other contract liability requirements" and the denominator of which is the total investment yield (income). Section 805 of the Code provides that the "policy and other contract requirements" means the sum of the following:

1. The adjusted life insurance reserves multiplied by the adjusted reserves rate,

2. The mean of the pension plan reserves at the beginning and end of the taxable year multiplied by the current earnings rate, and

3. The interest paid.

One component of "interest paid" is "amounts in the nature of interest" as set forth at p. 4, *supra*. The District Court found that Petitioner's payments as "excess interest" were "amounts in the nature of interest" within the meaning of Section 805(e)(2) and it is submitted that these findings are not clearly erroneous. The Government's regulations, quoted at pp. 4-6, *supra*, significantly provide that interest paid includes ". . . interest on insurance or annuity contracts for which no provision is made in the life insurance reserves. . . ." In the instant case, Petitioner, in its pension plan reserves (*i.e.*, life insurance reserves), only made provision for the maximum statutory interest (3½%). No amount of the "excess interest" which is at issue here is interest included in Petitioner's life insurance reserves. Moreover the *source* of the amounts credited to the pension plan reserves is not in dispute. These amounts arise solely from investments and do not involve mortality gains, expense savings or underwriting profits. Further, the above-quoted Regulations state that ". . . so-called excess-interest dividends. . ." are to be treated as amounts in the nature of interest within the meaning of Section 805(e)(2). Therefore, Petitioner submits that it has met all criteria in the statute and regulations and is entitled to exclude from its share of taxable investment income the "excess interest" payments here at issue.

The present Section 805(e)(2) was first enacted by Congress in the Revenue Act of 1942, as an amendment to the 1939 Code.[14] Section 201(c)(6)(B) of the Internal Revenue Code of 1939 provided a "deduction" for:

"All amounts in the nature of interest whether or not guaranteed, paid within the taxable year on insurance or

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[14] Revenue Act of 1942, 77th Cong., 2d Sess.

annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment, life, health or accident contingencies."

Further, Section 805(d)(2) of the 1954 Code, prior to the enactment of the 1959 Act, provided a "deduction" for:

"All amounts in the nature of interest whether or not guaranteed, paid or accrued within the taxable year on insurance or annuity contracts (or contracts arising out of insurance or annuity contracts) which do not involve at the time of payment or accrual life, health, or accident contingencies"

The Senate Finance Committee Report under the 1959 Act states that Section 805(e)(2) is, in substance, the same as Section 805(d)(2) of the 1954 Code. And, Section 805(d)(2) of the 1954 Code is substantially identical to Section 201(c)(6)(B) of the 1939 Code. Moreover, in connection with the Tax Reform Act of 1969, the Senate Finance Committee stated:

"As indicated above, the amounts deducted (excluded from taxable income of a life insurance company) in this respect has included not only amounts added to what are called life insurance reserves, but also, among other items, interest paid on indebtedness and amounts in the nature of interest on insurance or annuity contracts which do not involve, at the time of accrual, life, health or accident contingencies. At the time this latter provision was added to the Code in 1942, the Congress in its committee reports indicated that (t)his provision was to be interpreted broadly. It said that the provision includes amounts in the nature of interest such as so-called excess interest dividends and guaranteed interest

but Congress did not restrict the provision to only these items. In 1959 when the tax treatment of life insurance companies was substantially revised and broadened, this provision was nevertheless carried over substantially unchanged from prior law and again Congress indicated that it was to be interpreted broadly."[15]

Broadly interpreted, it is submitted that the language used in the predecessor sections of Section 805(e)(2) demonstrates that the phrase "life, health or accident contingencies" referred to the amounts *paid, i.e.*, the *source* of the amounts. If the source of the amounts paid involved life contingencies, such amounts, however designated, were not treated as attributable to the policyholders' share of the income but were rather treated as taxable to the company; however, if the source was investment earnings, they are to be excluded from the company's taxable investment income. It is undisputed that the source of the "excess interest" amounts in this case involved no life contingencies but related solely to income from investments made by Petitioner.

This position is strengthened by Section 805(e)(3) which was first enacted in the 1959 Act. That provision treats as "interest paid" discounts given by life insurance companies on premiums paid in advance on life and annuity contracts. Discounts are really interest in reverse. If premiums are paid in advance, the company has use of the money between the payment date and the due date upon which it earns money. The amount of discount is ordinarily measured by two factors: (a) time, and (b) use of money, *i.e.*, interest. There is no question that under Section 805(e)(3) the insurance

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[15] Sen. Fin. Comm. Rep. No. 91-552, First Sess. 1969-3 C.B. 423,601.

contracts involve life, health and accident contingencies. Nonetheless, the discounts referred to are treated as "interest paid" and, therefore, deemed to be earned on behalf of the policyholders and not the insurance company. In fact, all three subparagraphs of Section 805(e) relate to situations where a life insurance company derives or is deemed to derive income (discounts) from investment activity and not mortality or other savings. Therefore, such payments or discounts are treated as policy and other contract liabilities which result in an exclusion from the life insurance company's taxable investment income.

The Court of Appeals in this case interprets Section 805(e)(2) to say even though the "excess interest" arises solely from investment earnings, if these amounts are accrued on *contracts* which do involve life, health or accident contingencies, no exclusion of the amounts is permitted, even though they are, in fact, accrued, credited or paid. Petitioner suggests that, in accordance with Congressional intent, Section 805(e)(2) should be broadly construed, *viz.*, if the amounts do not arise from mortality gains or expense savings but arise solely from investment income and the same amounts are not included in the computation of the pension plan or life insurance reserves, then they are "amounts in the nature of interest" attributable to policy and other contract liability requirements.

Therefore, it is submitted that the proper interpretation of Section 805(e)(2) with respect to Petitioner's "excess interest" payments is to provide an exclusion:

> ". . . for all amounts in the nature of interest . . . for the taxable year on insurance or annuity contracts which [*amounts*] do not involve at the time of accrual life, health or accident contingencies."

The United States Court of Appeals for the Fifth Circuit erred in interpreting the statute to the contrary.

5. Alternatively, Petitioner submits that in excess of 65% of the excess interest amounts was paid or credited to these pension plan contracts at a time when the annuity or life contracts did not involve life, health or accident contingencies. With respect to the *annuity* contracts, the death benefit is always equal to the surrender value of the contracts prior to retirement age or age 65.[16] In other words, during the accumulation period from the date of issue, in each year when the amounts of "excess interest" are accrued with respect to these annuity contracts, these contracts do not involve life contingencies since there is no "insurance risk" attributable to these contracts. Moreover, the evidence showed that the amounts payable on death under the *life* contracts from approximate age 58 to age 65 were not greater than the reserves maintained for these policies. Therefore, because Petitioner's obligation to the policyholder in the event of death is the same as the cash value, Petitioner had no life insurance amount at risk or life contingencies at the time of accrual of the excess interest past age 58.

The District Court made no findings with respect to the life contingency status of any of these contracts at the time excess interest was accrued from year to year. Such findings, of course, were not required in view of the District Court's holding that Petitioner was entitled to exclude the total amount of "excess interest" accrued with respect to both the annuity and life contracts.

Even granting the Court of Appeals' construction of Section 805(e)(2) that the modifier of the words "life, health

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[16] See note 4, *supra*.

and accident contingencies" is the word "contracts" and not the word "amounts", nowhere in the record is there a finding that during the accumulation period on the annuity contracts and past the age when the cash value equals the death benefit on the life contracts, these various contracts, at the time of accrual, involved life, health or accident contingencies.

Further, a finding that at the *time* of accrual of "excess interest" the majority of these contracts did *not* involve life, health or accident contingencies is not inconsistent with the District Court holding that, for reserve purposes, these contracts *did* involve life, health or accident contingencies. Section 801 deals with the *computation* of life insurance reserves and defines such reserves as ". . . amounts . . . which are set aside to . . . liquidate . . . claims arising from . . . annuity . . . contracts . . . involving *at the time with respect to which the reserve is computed*, life, health or accident contingencies."[17] (Emphasis added) The reserves are computed at the time the premium is computed; that is, the date of issue. On the other hand, Section 805(e)(2) relates to the time when the amounts in the nature of interest ("excess interest") are accrued, a different point in time than when the reserves are computed. These time periods serve two different functions and two different purposes. One, a purpose when the reserve is computed in order to determine under Section 801 whether they qualify as "life insurance reserves"; and, two, at the time amounts in the nature of interest are accrued, to determine whether these amounts are to be excluded in addition to the amounts precomputed and pre-established as life reserves. Therefore, this Court should

[17] Section 801 generally deals with the question of whether or not an insurance company is a *life* insurance company. This question, in turn, depends upon whether the "life insurance reserves" plus certain premiums comprise more than 50% of the company's total reserves.

hear this appeal before this issue spawns substantial litigation, and clarify for the life insurance industry the parameters under which payments in the nature of excess interest are attributable to policy and other contract liabilities, and therefore, excluded from a life insurance company's taxable investment income.

CONCLUSION

For the reasons stated hereinabove, the Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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February 1978.

Supreme Court, U. S.
FILED
FEB 10 1978
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1124

SOUTHWESTERN LIFE INSURANCE COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA,
Respondent.

APPENDIX TO

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

(CONTAINING OPINIONS OF THE COURTS BELOW)

LARRY L. BEAN
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February 1978.

APPENDIX A

SOUTHWESTERN LIFE INSURANCE COMPANY,
Plaintiff-Appellee-Cross-Appellant,

v.

UNITED STATES of America,
Defendant-Appellant-Cross-Appellee.

No. 75-2675.

United States Court of Appeals,
Fifth Circuit.

Oct. 5, 1977.

Appeals from the United States District Court for the Northern District of Texas.

Before TUTTLE, GOLDBERG and CLARK, Circuit Judges.

TUTTLE, Circuit Judge:

This appeal presents for consideration the correctness of the trial court's judgment in a suit for refund filed by the insurance company by which judgment the trial court resolved several of the contested issues in favor of the taxpayer and the remaining issues in favor of the Commissioner. Since the parties are not content to leave the split

solution where it stands, it is necessary for us to give separate consideration to each of the many points at issue in the trial court. We shall first discuss the five issues which the trial court resolved in favor of the taxpayer, and which the Government has raised on its direct appeal to this Court. We then turn to the issues resolved in favor of the Commissioner and brought before us here by cross-appeal by the insurance company. Fortunately, both for the Court and for those affected by the opinion of this Court, counsel for the appellees followed the pattern of the Government's brief in discussing the several issues and, with an effort to get quickly to the merits of the controversy, counsel for the appellees followed almost verbatim the wording of the Government's brief in positing the issues which, on the Government's direct appeal, we state as follows:

I. ISSUES ON DIRECT APPEAL

1. Whether the district court erred in holding that it had jurisdiction to consider the merits of taxpayer's argument concerning its claimed deduction under Section 809(d)(5) of the Internal Revenue Code of 1954 for the increase in its reserves for nonparticipating contracts.
2. Assuming *arguendo* that the court was correct in determining that it had jurisdiction, whether Section 809(d)(5) which provides an additional

10-percent deduction for increases in life insurance reserves attributable to nonparticipating contracts, is subject to the Section 810 "spread rule" to the extent that the increase is due to reserve strengthening.

3. Whether the district court erred in holding that mortgage escrow funds, taxes and other amounts withheld from taxpayer's employees and various other amounts received or retained by taxpayer during the years in issue did not constitute "assets" of the taxpayer within the meaning of Section 805(b) of the Code.
4. Whether the district court also erred in holding that due and unpaid accident and health premiums were not includible in taxpayer's assets.
5. Whether the district court erred in holding that amounts paid by taxpayer to pension plans as "excess interest" on certain life insurance and annuity contracts constituted "amounts in the nature of interest" within the meaning of Section 805(e)(2) of the Code.

II. NATURE OF THE CASE

The issues in this case arise under the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. § 801 through 820. Congress has long recognized the difficulties in accurately establishing life insurance com-

pany annual income and, as reflected in the legislative history, S.Rep.No. 291, 86th Cong., 1st Sess., p. 5 (1959–2 Cum.Bull. 770–775) an apparent tax advantage is allowed to such companies on account of the nature of their long-term contracts which make it possible that what might appear to be income in the current year could conceivably be required later to fulfill insurance contracts. It is not deemed necessary for our consideration of the several issues involved to outline the precise method by which taxable income of life insurance companies is measured. It can be assumed, of course, from the fact that the issues are raised that their resolution will affect the ultimate income tax liability of the taxpayer.

III. ISSUES NUMBERS 1 AND 2—RESERVE STRENGTHENING UNDER SECTION 809(d)(5)

These issues are treated together, because it is the Government's position that the Commissioner's disallowance of the ten percent deduction for increases in life insurance reserves attributable to nonparticipating contracts under Section 809(d)(5) was not challenged by the taxpayer by a claim for refund before the filing of the suit now before the Court. If we find this contention to be correct, we do not reach the merits of the question.

The "ground" for the taxpayer's contention that it is entitled to a refund as to this

item arises from the unique provisions of the Code dealing with the treatment of certain reserves which is not brought about by normal additions to reserves. The Code authorizes the deduction in the tax year by an insurance company of the total amount normally added to reserves. In a case of "reserve strengthening" that is, when the company elects to increase its reserves beyond those required by § 808 of the Act, the Code requires that the deduction of the amount, here $820,068, be made over a period of 10 years, beginning the following year. This is called the "spread" rule. The statute further authorizes the deduction of an additional 10% of the amount of any reserve increase attributable to nonparticipating contracts. The taxpayer claims, and the trial court held, that this 10% could all be deducted for the tax year because it was not covered by the "spread" rule. The government contends, to the contrary, that the statute requires the same treatment of this additional 10% as is given to the principal amount itself: None is deducted in the tax year but deductions must be spread over the succeeding 10 years. Resolution of this issue depends upon the construction of § 809(d)(2), 809(d)(5) and 810(d) of the Code.

Section 7422 of the Internal Revenue Act of 1957 provides as follows:

> "*No Suit prior to filing claim for refund*—No suit or proceeding shall be maintained in any court for the recovery

of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary or his delegate, according to the provisions of law in that regard, and the regulations of the Secretary or his delegate established in pursuance thereof." 26 U.S.C. § 7422(a)

The Supreme Court has long since held that a failure to raise factual and legal grounds in a claim for refund bars a recovery on such a claim in a subsequently filed suit for refund, *United States v. Felt & Tarrant Manufacturing Co.*, 283 U.S. 269, 51 S.Ct. 376, 75 L.Ed. 1025 (1931); *Angelus Milling Co. v. Commissioner of Internal Revenue*, 325 U.S. 293, 65 S.Ct. 1162, 89 L.Ed. 1619 (1945). This Court has stated in *Alabama By-Products Corp. v. Patterson*, 258 F.2d 892, 900 (1958):

"All grounds upon which a taxpayer relies must be stated in the original claim for refund so as to apprise the Commissioner of what to look into. The Commissioner can take the claim at its face value and examine only those points to which attention is necessarily directed. . . . Anything not raised at that time cannot be raised later in a suit for refund. . . . ."

In this case it is clear that the taxpayer has in no way raised the reserve strengthening issue as to the *extra* ten percent in the claim for refund which it filed for the year 1958. The only basis upon which the taxpayer could contend to the contrary is in a document denominated "Rider No. 8" to the 1958 claim. For the better understanding of the holding on this issue we duplicate this rider herewith:

"Schedule E–2, Part III
Deduction for Nonparticipating Contracts

	End of Year	Beginning of Year	Increase or Decrease
Per R.A.R.	$221,143,632	$209,949,877	$11,193,755
Claim adjustments			
(a) Reserve strengthening at 12–31–58 which was considered as being made at 12–31–54	(820,068)	(820,068)	-----
(b) Reserves of policies which became participating during the year		(2,949,993)	(2,949,993)
Per Claim For Refund	$220,323,564	$206,179,816	$14,143,748"

The taxpayer contended that item listed (b) "reserves of policies which became participating during the year," had been treated erroneously, and should be changed by increasing the deduction for nonparticipating contracts by the sum of $2,949,993. In the tabulation shown above, it listed the item of $820,068 under this general heading for the computation of the deduction for nonparticipating contracts but it made no claim thereabout. It plainly indicated that the taxpayer made no contest with respect to disallowance of the bracketed amount, since it showed the amount both at the end of the year and the beginning of the year. There is nothing on this schedule or any other part of the claim or any document submitted to the trial court by which the taxpayer raised the contention which it now seeks to raise in the suit for refund that the Commissioner had improperly disallowed the item of 10% of $820,068 during the tax year 1958. The trial court's response to the Government's challenge to its jurisdiction to consider this claim was "the Government has been well advised of taxpayer's claim on this issue, through both the claim for refund and conferences with its agents. Accordingly, the issue is properly before this Court and this Court has jurisdiction over the subject matter." The Commissioner contends that there is no basis for that part of the trial court's statement that the Government was well advised "through

conferences with its agents." Appellees only response to this is that:

> "In Rider 8, the adjustment was listed as erroneously have been determined by the agent as occurring in 1957 rather than 1958. There is also no question but that on the examination of taxpayer's claim for refund the examining agent changed his position and recognized the reserve increase as occurring in 1958 but reduced the amount of increase in reserve on which the Section 809(d)(5) deduction was based by the amount of $820,068. All of these facts are clearly disclosed by taxpayer's 1958 income tax return, its claim for refund, Rider 8, and by the fact that the examining agent changed his position that the reserve increase occurred in 1958, not 1957. He could not have made the change without knowing that taxpayer was making a claim with respect to this issue in its claim for refund which was different from that asserted by the Government. Thus, the district court's fact finding is not clearly erroneous."

This statement is faulty in several respects. In the first place, in Rider 8, the adjustment was not listed as erroneously having been determined by the agent as occurring in 1957 rather than 1958. It was simply listed as having been "considered as being made at 12–31–57." The fact that on examination of taxpayer's claim for refund the examining agent changed hi sition

and recognized the increase as occurring in 1958 does not indicate that anything was done or said with respect to taxpayer's contention that 10% or $820,068 could be deducted during the tax year rather than over a ten year period following the tax year in question. Nothing stated by defendants indicates that the taxpayer met the requirements of the statute, as interpreted by the courts, that a written claim calling specific attention to the alleged error and the basis on which the claim was being made was ever communicated to the Commissioner.

We must conclude, therefore, that the trial court did not have jurisdiction to consider the Section 809(d)(5) claim on the merits. This, then, disposes of issues numbered 1 and 2, *supra*.

IV. ISSUE NUMBER 3—MORTGAGE ESCROW FUNDS AND OTHER AMOUNTS HELD IN CASH BY TAXPAYER FOR EMPLOYEES AS "ASSETS"

(a) Mortgage Escrow Funds. For simplification, we adopt the formula as stated in the government's brief to give an indication of the importance of ascertaining whether certain items carried on the taxpayer's books as assets are "assets" as defined in § 805(b)(4) and as used to compute taxpayer's tax liability under the act. There is an exclusion for the policyholder's share of the investment income as a step in

the computation of the tax. In highly simplified form, the excluded portion of a company's investment income is computed as follows:

$$\frac{\text{Investment Yield}}{\text{Assets}} = \text{Earnings Rate}$$

$$\text{Earnings Rate} \times \text{Reserves (adjusted)} + \text{interest paid} = \text{exclusion}$$

It is clear that the higher the amount of the company's assets in this formula, the lower is its earnings rate and thus the higher would be its taxable share of investment income.

The mortgage escrow funds, represented by bank deposits in the general bank accounts of the taxpayer, are claimed by the company not to fall within the definition of assets for the purpose of this computation. The trial court accepted this view of the matter and concluded that *Liberty National Life Insurance Company v. United States*, 463 F.2d 1027 (5th Cir. 1972) required this result.

During the years in question, the taxpayer held substantial amounts of mortgages on real estate, some having been made directly between the taxpayer and the borrower and others having been made through mortgage loan correspondents or servicing agents who serviced the loans pursuant to written contracts entered into with taxpayer. Under the standard contracts employed by the taxpayer, the mortgagor

was required to make monthly payments which consisted of a reduction of principal, interest, and a sum sufficient when added to subsequent monthly payments to enable the taxpayer to pay the year's property taxes and insurance when these items should come due. The items other than principal and interest are called by both parties "mortgage escrow funds." These funds were deposited in the general checking accounts of the taxpayer. During the tax years, the cash of the taxpayers, which included the escrow items, was deposited in approximately 1500 different banks, which held annually reported balances varying from a few hundred dollars to approximately one million dollars.

The amount of "mortgage escrows" was substantial, amounting on December 31, 1958 to $333,036.18 and increasing thereafter to $674,608.89 in 1965.

In addition, correspondents or servicing agents had on deposit in their general bank accounts much more substantial amounts of cash in 1963, 1964, and 1965 all subject to the control of the taxpayer. The amounts of these escrows for the tax years follows:

Mortgage Escrow Funds Held by Taxpayer:					
1958	1959	1960	1961	1962	1963
333,036.18	363,965.29	342,321.75	577,562.96	643,952.09	586,194.95
Service Company Escrow Funds Held by Taxpayer:					
1,176,551.10	1,040,980.22	1,105,624.05			
1964	1965				
621,415.61	674,608.89				

All of these amounts were included as assets on the Annual Statement of the taxpayer.

Section 805(b)(4) contains a definition of the term "assets" for purposes of determining an insurance company's earnings rate:

> "For purposes of this part, the term 'assets' means all assets of the company (including non-admitted assets), other than real and personal property (excluding money) used by it in carrying on an insurance trade or business."

This Court has held in *Liberty National Life Insurance Co., supra*, that monies held by life insurance companies *in trust* belong to someone else and are not assets of the insurance company. Furthermore, the Court determined that as to the escrow funds there before the Court the company "serves as trustee." The Court did not refer to the actual language of the mortgage instruments to show the basis for its determination that "the monies received are held for the use of the mortgagors. Liberty cannot lawfully disburse these funds for any purpose other than in satisfaction of the trust arrangements." 463 F.2d at 1029.

The difficulty here is that we do not know what was stated in the mortgage documents referred to in the *Liberty National* case to cause the court to hold that the monthly payments of the escrow amounts created a trust for the mortgagor with the insurance company as trustee; nor, in this case, do we know the terms of the agreements between mortgagors and insurance company. The company, as plaintiff in this refund suit, did not deem it

necessary to prove the terms under which these payments were made to the taxpayer. Thus, proof is lacking on whether the agreement created a trust of the kind alluded to in *Liberty* or merely created the relation of debtor and creditor. There is no evidence in this record of a single document that creates an express trust, although both parties treated the matter as we know it actually occurred, that is, that each dollar deposited in the mortgage escrow account represented a payment made by a mortgagor against the company's later payment of certain items that were payable once a year.

Moreover, the government's brief states that the taxpayer has conceded in a trial brief that none of the mortgage documents created an express trust. This statement is not challenged by any of the subsequent briefs filed by the taxpayer. Since it is clear that the money was paid under a written agreement and since the company does not undertake to claim that it has breached any trust relationship by which it got possession of these funds or mishandled them after receiving them, we fail to see how a constructive trust could be impressed on the funds as against the company. *See, e. g., Blankenship v. Citizens National Bank of Lubbock*, 449 S.W.2d 77, 79 (Tex.Civ.App. 1965); *Nichols v. Acers Co.*, 415 S.W.2d 683 (Tex.Civ.App.1967). So far as the record discloses the company had every right to consider that its receipt of these funds from

the various mortgagors created merely an obligation to pay the taxes and insurance when they became due, a contractual obligation and nothing more.

Not only did the taxpayer fail to prove that these funds actually belonged to others than the mortgagor by producing an agreement to that effect but also the company's treatment of the funds was clearly inconsistent with its present contention that they were trust funds. It is clear that taxpayer did not deal with these funds in the manner required of trustees by the Texas statutes, Article 7425b, § 10, p. 228. In *Langford v. Shamburger*, 392 F.2d 939 (5th Cir. 1968), this Court construed this statute and we there held that it forbids a trustee from comingling trust funds with its own, citing and construing the Texas case, *Langford v. Shamburger*, 417 S.W.2d 438 (Tex.Civ.App. —Ft. Worth, 1967, *writ ref'd n. r. e.*) which in turn cites Bogert on Trusts as follows:

> "The trustee may violate the duty of loyalty by lending trust funds to himself. He thus brings into play a conflict of private and representative interests. As lender it is his duty to get the best terms possible as to interest, security, and maturity. As debtor his impulse is naturally in the direction of getting the money at the lowest rate and often on other terms not advantageous to the lender. If he lends to himself, he cannot give an impartial judgment as to the adequacy of the security offered.

> If there is no formal loan but a trustee mingles the trust funds with his own and uses them in his private business, the transaction can be treated as a breach of trust on either of two theories, namely, that of conversion of the trust property, or disloyalty. Bogert Trusts and Trustees, 2d Ed. § 543(J), p. 548."

417 S.W.2d at 444.

This Court then said:

> ". . . Under section 10 of the Texas Trust Act, the section quoted with approval from Bogert, and the language in *Wichita Royalty Company*, supra [*Wichita Royalty Co. v. City Nat. Bank*, 127 Tex. 158, 89 S.W.2d 394], it is improper for trustees to comingle trust funds with personal funds and to retain large sums of trust money in personal bank accounts even after trust bank accounts have been opened. To say nothing of the cases and commentary, both practices fly in the face of the Act's provision against loans of trust funds by a non-corporate trustee to himself. (Footnote omitted)."

Furthermore, in *Langford*, this Court held that Texas law mandated a holding that the borrowing of trust funds (which includes depositing such funds in the personal account of the borrower) constitutes illegal self-dealing "because the trustee inevitably benefits, and, just as inevitably, the beneficiaries suffer." *Id.* at 944.

In *Liberty*, even though the Court determined that the funds there were trust

funds, we pointed out that if such funds were used for the benefit of the insurance company, we would consider them to be assets within the meaning of § 805(b)(4). We said:

> "Unless it could be shown that the escrow funds actually were used for investment or that they had indirectly served to permit Liberty to invest more assets than it ordinarily could, we cannot see how it can be said that the escrow funds were assets of the company. In our view the only type of benefit which Liberty might receive from the escrow funds, which in turn would result in our holding that the funds were assets within the meaning of § 805(b)(4) would be the freeing up of other assets for investment. Because we find no evidence indicating that such benefit inured to Liberty, we hold the district court's contrary finding to be clearly erroneous."

463 F.2d at 1031.

This Court had previously held in *Langford, supra*, that under Texas law, which controls here, the legal consequences of the relationship between mortgagor and mortgagee here—such comingling of funds—confer a benefit on the comingler. In that case we said:

> "In developing this idea, we will assume the cash balances in the trustees' accounts never fell below the amounts owing from their accounts to the trusts. (Footnote omitted). We note first that it

> is both a decided advantage and an unusual occurrence for a person to have large sums of money from outside sources in his bank account for a period of years on an interest-free basis. As part of the same picture, we observe that those from whom these funds are withheld are the losers because their money is earning no interest. Even though the borrower never spends the money but rather lets it stand idle so that he can always pay whatever he owes, certain benefits nevertheless accrue to him: With a larger account, he can borrow money from the bank at lower interest rates, reduce the service charges on his account, and perhaps even become a director of the bank. In short, the borrowed funds serve as a cushion for his account. While the borrower has this cushion, the one from whom the money is borrowed has no opportunity to let his money either appreciate by investment or earn interest in a savings account. With the advantages inherent on one side and disadvantages on the other, it would be unthinkable for courts to say that a trustee, on whom the highest duty of loyalty is imposed, can be the borrower and his trust the lender."

Id. at 944.

Of course, we do not hold that if the taxpayer should violate the Texas statute with regard to the handling of trust funds it necessarily follows that such funds are not indeed trust funds. We point to this

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handling of the matter by the taxpayer only to indicate that on this record which is otherwise silent as to the existence of a trust, the company's conduct was inconsistent with its present contention that these funds "belong to someone else."

Not only was the handling of these funds by the taxpayer inconsistent with its claim that they were trust funds but a further distinction appears from the fact situation which was discussed by the court in *Liberty*. That is, that there is proof in this record that the general funds of the company, including the mortgage escrow amounts, were scattered over some 1500 different banks, apparently in every hamlet, town and village in a large area of the southwest. It would seem that this use of the escrow funds must have been for some business purpose which would, of course, be a benefit to the taxpayer which the *Liberty* court found lacking.

Essentially, we have a simple issue: Were these funds assets of the insurance company or did they belong to someone else? The presumption of correctness that follows the deficiency notice places the burden on the taxpayer of establishing all matters necessary to show that it does not owe the taxes in question. *Helvering v. Taylor*, 293 U.S. 507, 55 S.Ct. 287, 79 L.Ed. 623; *Gibbs v. Tomlinson*, 362 F.2d 394 (5th Cir. 1966).

We conclude that not only did the taxpayer not carry this burden by proof that the money carried in these bank accounts were not assets but the proof, such as it was, is to the contrary. The trial court erred in holding that these funds were not assets of the company within the contemplation of the statute.

(b) Amounts Withheld from Taxpayer's Employees and Miscellaneous Other Funds Held by Taxpayer. These items, which together would add something over one million dollars to the assets reportable for 1962 and in excess of two hundred thousand dollars in the years 1963, 1964 and 1965, included an item denominated "liability for cash held in escrow—Roberts," "withholding taxes—federal, state, and city," "mortgage participation—Sun Ray," "amounts deducted from employees' pay to be used for various items" and "miscellaneous." The government contends that these items should all be treated in the same manner as are the mortgage escrow funds. The taxpayer says with respect to these items. "These same principles [the principles applicable to treatment of 'mortgage escrow funds'] and arguments apply with respect to amounts withheld from taxpayer's employees and miscellaneous other funds held by taxpayer as agent or trustee. *See* § 7501 and *Arcnell [Artnell] v. Commissioner*, 18 [48] Tax Ct. 411 (1967)."

Reference to § 7501 makes it plain that so far as the amounts included any

federal internal revenue tax, these amounts were held by the company in trust for the benefit of the United States. Title 26 U.S.C. § 7501 provides:

> "(a) General rule—Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose."

The government says that this section does not mean what it says and that it does not create a true trust. It takes the position that it is only when the amounts become due and become unpaid that a true trust relationship is created. Although the taxpayer does not undertake to respond to this argument, we are not impressed with the idea that once the government requires the collection by an employer of part of the taxes owed by his employee, by deducting the amount from the employees' compensation and states that such amounts "shall be held to be a special fund in trust for the United States" it doesn't mean precisely what it says. So far as these amounts are concerned, they are not part of the taxpayer's assets.

In view of the fact that the taxpayer agrees that the same considerations that apply to the mortgage escrow funds shall be applied to these other items, and does not undertake to distinguish between them, we treat them in that manner, except for the withheld federal internal revenue taxes. The trial court therefore erred in excluding such items from the company's assets for the tax years in question.

V. ISSUE NUMBER 4: "DUE" AND "UNPAID" ACCIDENT AND HEALTH PREMIUMS AS "ASSETS."

During the tax years in question, taxpayer sold both cancellable and non-cancellable accident and health insurance policies in addition to its life insurance business. The policies typically provide for a grace period of 31 days during which the policy remains in force notwithstanding the failure of the insured to pay the premium on the due date. As of the end of each of the years in issue, taxpayer had a substantial number of policies in force by virtue of the grace period provision. The premiums which would ultimately be paid on these if they were kept in force are referred to by the taxpayer on its books and statements as "due and unpaid."

Even though taxpayer had no legal claim or entitlement to these amounts if the policyholders should elect not to renew them, experience had dictated that a very substantial number were actually paid and the

taxpayer included them in "admitted assets" in its annual statement for the years in question. Due and unpaid accident and health premiums are also included in taxpayer's "gross premiums" in the summary of operations section of its annual statements and in its gross premiums for federal income tax purposes. However, for the purpose of computing its assets under § 805(b) of the Code, taxpayer did not include any portion of the due and unpaid premiums.

Although the trial court held in the government's favor as to a seemingly similar item of "due and unpaid" life insurance premiums, which judgment has since submission of this case been partially approved by the Supreme Court's decision in *Commissioner of Internal Revenue v. Standard Life & Accident Ins. Co.* (No. 75-1771) —— U.S. ——, 97 S.Ct. 2523, 53 L.Ed.2d 653, dec. June 23, 1977, the court concluded that due and unpaid accident and health premiums did not constitute assets based on its finding that:

> "No life insurance reserves are maintained or established as a result of the due and uncollected premiums on accident and health policies, therefore, they differ from deferred and uncollected premiums on life insurance contracts."

It is true that in the formula used in determining life insurance company taxes, the term "reserves" in the equation refers to "life insurance reserves." The government concedes that there is no proof on this

record that Southwestern Life Insurance Company set aside as a part of its life insurance reserves any amount representing the ordinary accident and health policies. The taxpayer, however, concedes that such amounts were set aside for some non-cancellable health and accident insurance contracts.

While the taxpayer contends that the amount set aside for such "few" policies are entitled to a different treatment, the trial court did not make this determination. It found that no such reserves were set aside even for non-cancellable policies. This is evidently wrong. The thrust of the Court's opinion in *Standard Life, supra*, is that if the taxpayer benefitted taxwise from setting aside the amount as reserves, then it must be treated uniformly when its inclusion favors the tax gatherer. This issue must be remanded to the trial court to determine whether, and to what extent, the setting aside of reserves for these policies benefitted taxpayer in the several computations, and then to require a corresponding inclusion of this amount as assets under § 805(d).

VI. ISSUE NO. 5: "AMOUNTS IN THE NATURE OF INTEREST"—§ 805(e)(2).

In addition to the selling of life insurance, Southwestern is in the business of administering qualified pension and profit sharing plans. It maintains life insurance reserves with respect to the contracts setting up these plans. Under state law, the

maximum interest rate taxpayer can use in computing these reserves is 3½%. In order to be competitive with banks and other financial institutions that administer pension plans, taxpayer enters into an agreement with the plans that purchase its contracts in which it agrees to pay these plans an annual amount in excess of the 3½% interest used in computing the reserves. The taxpayer is enabled to do this because it actually earned on its investments of the reserves substantially in excess of 3½%. This excess, of course, does not become a part of the reserves; nevertheless, in an equation utilized by the statute to determine the exclusion from investment earnings of that part of investment income deemed to be the policyholder's share, the statute treats all income derived from reserves uniformly. That is to say, the statute provides for an equation to determine the exclusion from the taxable investment income which gives the same effect in the ultimate determination of tax liability to that part of the income which is added to the reserve and to that part which is in excess of the statutory rate. That equation is expressed as follows:

$$\frac{\text{"policy and other contract liability requirements}}{\text{total investment yield}} \times \text{each item of investment yield} = \text{exclusion for policyholders' share."}$$

It will be apparent that an increase in the numerator of this fraction would increase the exclusion for the policyholders' share and thus decrease the taxable portion of investment income.

The numerator "policy and other contract liability requirements" is equal to the sum of three items (§ 805(a)):

1) the adjusted life insurance reserves, multiplied by the adjusted reserves rate,

2) the mean of the pension plan reserves at the beginning and end of the taxable year, multiplied by the current earnings rate, and

3) the interest paid.

Thus far, there appears to be no ambiguity. But § 805(e)(2) provides that "the interest paid for any taxable year" includes:

> ". . . (2) *Amounts in the nature of interest.*—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies."

It is only under this provision that the taxpayer claims that the payments of the "excess interest" are deductible as "interest paid" as one of the three elements constituting the numerator of the above fraction.

The commissioner contends that a proper interpretation of this section under normal rules of grammar would preclude the use of these payments to increase the amount of "interest paid" and furthermore that any different construction would, in effect, give a double benefit to the taxpayer because the excess earnings on its reserves, as we have already pointed out, have already been included in the numerator of the fraction because *all* of the company's earnings on reserves, including the excess over the 3½% rate, have been included in the term "the adjusted life insurance reserves."

The taxpayer does not deny that its construction of § 805(e)(2) provides some increased benefits to the extent that it is permitted to deduct as interest amounts which it has never reported as income. However, it contends that Congress intended to achieve this result in order to equalize insurance companies engaged in this business with non-insurance company competitors. The record does not indicate to what extent the special tax provisions for insurance companies places them in a competitive position with others. We can't simply construe one provision of the definition of interest as one part of a complex formula for determining taxable income for an insurance company by comparing it with some particular part of an ordinary income tax statute affecting non-insurance company taxpayers. Taxpayer also contends that a proper construction of § 805(e)(2) would yield the result for which it contends.

The construction argument revolves around the question whether the words "which do not involve, at the time of accrual, life, health, or accident contingencies" modify the word "amounts" or the word "contracts." The taxpayer contends that the section should be construed to read as follows: "All amounts in the nature of interest . . . for the taxable year . . . which do not involve, at the time of accrual, life, health or accident contingencies."

The government concedes that if this is the proper construction, then these amounts do become allowable as interest. However, it contends that the section should be construed to read as follows: "All amounts in the nature of interest . . . for the taxable year on insurance or annuity contracts . . . which do not involve, at the time of accrual [of the amount], life, health, or accident contingencies." Citing Strunk & White, *The Elements of Style*, 1962 ed., pp. 22–24, the government says it is a basic rule of English grammar that modifiers in a sentence should be placed, whenever possible, next to the word they are intended to modify. Under this rule, of course, the words "which do not involve, at the time of accrual, life, health or accident contingencies" would modify the word "contracts" and would not modify the word "amounts." It is clear that if the phrase modifies "contracts" the trial court was in error in sustaining the taxpayer's position

because it is plain that the contracts do involve life contingencies.

It seems unlikely that in drafting such a provision as this, Congress would use a structure that doesn't make sense, which would be the case if we construed the section to mean "all amounts . . . which do not involve . . . contingencies." It is not plain how "an amount," presumably accrued on the books, could "involve, at the time of accrual, life, health, or accident contingencies." What does this mean? How does an amount ever involve anything? In order to give it meaning, the taxpayer must interpret it as saying "all amounts whose computation does not involve, etc."

On the contrary, the straightforward reading of the section points to the interpretation urged by the commissioner since it has a complete meaning as written. That is, "all amounts in the nature of interest . . . on insurance or annuity contracts . . . which do not involve, at the time of accrual . . . contingencies." Here it is plain that these contracts did involve "life, health, or accident contingencies" and, therefore under this interpretation the amounts did not meet the requirements of the section.

Moreover, as pointed out by the commissioner, substantial amounts earned on the reserves in excess of the 3½% rate, although not required or permitted to be retained as reserves, were nevertheless utilized by the company as part of the reserves to increase the size of the numerator of the fraction. If taxpayer is permitted to add as a third element of the numerator in addition to the life insurance reserves and the pension plan reserves, an item of interest which largely corresponds with untaxed investment income-held for the company's use, this would clearly give a double benefit to the taxpayer for this item to the extent that they were the same.

We conclude, therefore, that a construction of § 805(e)(2) that the words "which do not involve, at the time of accrual, life, health, or accident contingencies" modify the word "contracts" rather than the word "amounts" is more nearly in accord with the Congressional purpose. The trial court erred in holding to the contrary.

VII. ISSUES ON CROSS-APPEAL

As stated by the taxpayer in its cross-appeal from those parts of the judgment of the trial court adverse to it, the issues on cross-appeal are:

(1) Whether the district court erred in holding that the cost of policies acquired through an assumption reinsurance transaction was not deductible in full in the year of the transaction;

(2) Whether the district court erred in holding that unearned interest on so-called policy loans constitutes taxable investment income;

(3) Whether the district court erred in holding that in computing the special deduction for increases in reserves for non-participating contracts under Sec. 809(d)(5), the reserves for contracts which become participating during the taxable year were includable in the beginning of the year reserves;

(4) Whether the district court erred in holding that losses for bad debts on advances to life insurance agents were not deductible in computing net investment income under Sec. 805;

(5) Whether the items of deferred and uncollected premiums on life insurance and annuity contracts, accident and health premiums due and unpaid, unearned interest on policy loans, advances to life insurance agents, amounts due from reinsurers, participation interest in reinsurance pools, unamortized cost of assumption reinsurance, mortgage escrow funds and amounts held by taxpayer as agent or trustee for others constituted "assets" within the meaning of Sec. 805(b)(4) of the Internal Revenue Code.

VIII. CROSS-APPEAL ISSUE NO. 1: CURRENT DEDUCTIBILITY OF AMOUNT PAID FOR ACQUISITION OF ATLANTIC LIFE INSURANCE COMPANY STOCK.

In 1961, taxpayer purchased the entire capital stock of the Atlantic Life Insurance Company from its sole stockholder, Life Companies, Inc. The total price for the acquisition was $128,226,896 which was represented by cash of $29,000,000, reserve requirements assumed $94,536,860, other liabilities assumed $4,690,036. Taxpayer received tangible assets agreed to have a fair market value of $118,798,778, leaving an excess of $9,864,131 which it allocated on its books to the value of the "insurance in force" acquired from Atlantic. It is not disputed that taxpayer was willing to pay this amount more than the fair market value of the assets it received because of its expectations of profiting in the future from the insurance contracts which had already been written by Atlantic. The taxpayer deducted the full amount of $9,864,131 as an ordinary and necessary business expense in the nature of commissions. The Commissioner disallowed the deduction but allowed the taxpayer to amortize the amount over the average life of the policies, determined to be ten years. The trial court sustained the Commissioner's position.

The Commissioner supports the trial court's decision upon the fundamental principle of federal taxation that the cost of acquiring a capital asset may not be currently deducted but rather must be amortized or depreciated over the useful life of the asset. On the other hand, the taxpayer

contends that all costs of "putting policies on the books" are currently deductible as a cost of doing business whether such cost is represented by payments to salesmen currently selling the company's policies or in payment for the 100,000 policies theretofore written by Atlantic.

Treasury Regulation 1.87-4 supports the Commissioner's view of the matter. It provides:

> *Special Rules.*
>
> (d) Certain other reinsurance transactions. . . .
>
> (ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957.
>
> (b) Treat any amount paid to the reinsured, to the extent such amount meets the requirements of section 162, as a deferred expense under section 809(d)(12) and amortize such amount over the reasonably estimated life (as defined in subdivision (iii) of this subparagraph) of the contracts reinsured, irrespective of the taxable year in which such amount was paid to the reinsured."

The taxpayer claims that this regulation has no statutory support, is contrary to the clear congressional mandate and is therefore invalid.

It cannot be gainsaid that the government's basic premise is correct. That is, as stated in *Woodward v. Commissioner of Internal Revenue*, 397 U.S. 572 at 574, 90 S.Ct. 1302, at 1304, 25 L.Ed.2d 577:

> "Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible. (Footnote omitted). *See* Internal Revenue Code of 1954, § 263. . . . If an expense is capital, it cannot be deducted as 'ordinary and necessary,' either as a business expense under § 162 of the code or as an expense of 'management, conservation, or maintenance' under § 212. (Footnote omitted)."

Thus, it is clear that unless there is some provision peculiar to the taxation of insurance companies that makes an exception to this rule the amount paid by the taxpayer here for the asset represented by the outstanding policies acquired from Atlantic cannot be deducted currently, but must be deducted on an amortized basis as provided by the appropriate treasury regulation.[1]

1. The taxpayer contends that this regulation does not fit a situation where the amount paid is not paid to the "reinsurer" but is paid to the owner of the reinsured's capital stock. This argument, it seems to us, backfires in the sense that if this agreement, which was a three-way contract including an agreement with the reinsured to reinsure its policies does not fall within the language of the regulations, because the purchase price was paid to someone other than the reinsured itself, it is clearly then the price paid by the taxpayer to acquire the capital stock of a life insurance company, which by all definitions would be a capital expenditure.

Moreover, this Court has heretofore analyzed the effect of such a contract. In *Mutual Savings Life Ins. Co. v. United States*, 488 F.2d 1142 (C.A.5 1974) we held expressly that "if the reinsurer has paid consideration for the policies, the payment cannot immediately be deducted, but must be amortized over the estimated life of the contracts." 488 F.2d 1142, 1144. Here, it is plain from the undisputed evidence at the trial, that the $9,800,000 was paid as consideration for the outstanding policies.

The taxpayer's effort to equate the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison. Atlantic has already paid commissions to its agents for the acquisition of these same policies and the value of the policies to the taxpayer here in no way represents that cost of putting the business on the books of the company. It represents, instead, an estimate of the current value to the taxpayer that is represented by having these policies on its books with the expectation of the continuing premiums to be paid in the future. This may or may not approximate the total loading cost to Atlantic. Certainly it cannot be said to proximate the amounts paid as commissions when the policies were originally solicited. Southwestern points to no statutory provision, other than the general

statutory authorization for the deduction of current expenses on which it seeks to rely as a basis for its broad contention that any payment that may be required as a cost of putting the business on the books must be currently deductible.

The trial court correctly decided this issue in favor of the government.

IX. CROSS-APPEAL ISSUE NO. 2: TREATMENT OF ADVANCE INTEREST ON POLICY LOANS.

As provided for by the terms of the insurance policies issued by the taxpayer, Southwestern made loans to its policyholders, the insurance contracts providing such loans would be made up to the amount of the cash surrender value of the individual policy. Under the express terms of the policy, interest was paid in advance to the end of the policy year, and annually thereafter, in advance, on the policy anniversary date for the ensuing year. Payment of interest in advance could be accomplished in one of two ways. The policyholder could pay the company in cash for the year's interest or the company would advance to him the amount of the loan requested less 5% for the remaining term of the policy year. Interest for the ensuing policy year which was not paid in cash was added in advance to the amount of the principal debt. In either event, when cash was not paid for advance interest, the cash surren-

der value of the policy was reduced by such amount. Under the policy agreement, any prepayment of the loan before the end of the policy year would require repayment by the taxpayer of the rateable amount of unearned interest. The same thing occurred if the policyholder should surrender his policy for the cash value or if he should die during the policy year.

The taxpayer showed such amounts of interest for the entire term of the policy loan on its books as "interest on policy loans." Neverthcless, the taxpayer reported only such part of these payments as represented a ra eable amount of interest up to the end of the tax year, rather than the full amount collected as investment income. The government contends, and the trial court held, that the entire amount collected by the taxpayer as "interest on policy loans" was taxable when received or charged against the policy's cash surrender value.

The taxpayer undertakes to support a thesis that this transaction was not a loan at all, but merely a return to the taxpayer of a part of the value of his policy—in other words, a partial cash surrender.

The method which taxpayer used in keeping its books of account by accruing the entire amount of interest, even though taxpayer may, in the event of prepayment or death of the policyholder, be required to make a repayment of a rateable amount, is

consistent with the accrual basis of accounting. There is no reason to permit the taxpayer, for tax purposes only, to treat a transaction which it and the policyholder expressly considered to be a loan and the payment of interest to be something entirely different. This is the view taken by the Court of Appeals for the Fourth Circuit in *Jefferson Standard Life Ins. Co. v. United States*, 408 F.2d 842, 856–857 (C.A.4 1969) and the Seventh Circuit in what we conclude is a comparable situation in *Franklin Life Ins. Co. v. United States*, 399 F.2d 757, 762–763 (C.A.7 1968).

Even though we were not to hold that the legal result is as followed by these two courts, it is true, as the government points out, that no proof was introduced in this record to show what proportion of the total amounts in dispute dealing with this issue were amounts actually paid in cash by the policyholder, and thus clearly reportable as interest and what amount was simply charged against the cash surrender value of the policy. The burden is, of course, on the taxpayer to show his entitlement to recover in a suit of this kind and such failure of proof would bar recovery of the amounts involved in this issue in any event. The trial court correctly held for the United States on this issue.

X. CROSS-APPEAL ISSUE NO. 3: COMPUTATION OF SPECIAL DEDUCTION FOR INCREASES IN RE-

SERVES UNDER § 809(d)(5) FOR THE YEAR DURING WHICH SUCH CONTRACTS BECOME PARTICIPATING CONTRACTS.

The taxpayer's claim here arises from a provision of the statute which provides a special deduction to insurance companies if during the year there is an increase in the company's reserves for its nonparticipating contracts.[2] This deduction amounts to 10 percent of the increase during the taxable year in a company's reserves for its nonparticipating contracts.

2. Section 809(d)(5) provides as follows:

"(d) Deductions. For purposes of subsection (b)(1) and (2) there shall be allowed the following deductions: . . .

(5) *Certain nonparticipating contracts.*—An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

As pointed out by the taxpayer, Congress recognized that companies issuing nonparticipating contracts need an additional reserve cushion. The government does not contest the theory upon which Congress authorized this additional 10 percent deduction. It merely questions the manner in which the annual increase is computed.

The government takes the position that there is a clearly recognized amount on the taxpayer's books at the beginning of the year representing Reserves for Nonparticipating Contracts and that there is a corresponding figure at the end of the tax year. If the figure at the end of the year exceeds that at the beginning of the year, the government contends, then the 8.09(d)(5) deduction of 10 percent of that difference is available to the taxpayer. The insurance company, on the other hand, claims that the difference should be greater than that arrived at by the simple calculation of subtracting the beginning figure from the closing figure for the year. It says that the reserves attributable to those contracts which are converted from nonparticipating to participating during the year should be excluded from the opening amount of capitalized reserves for nonparticipating contracts at the beginning of the year because there will be no reserves attributed to such contracts at the end of the year because in the meantime they have become participating contracts.

We conclude as did the trial court that this construction by the taxpayer is not based on any reasonable construction of the statute or regulations. Congress was concerned about the impact of an increase in any reserves required for nonparticipating contracts in gross, that is to say, it viewed the financial impact on a stock company, when compared with mutual insurance companies, by having to increase its reserves during a particular tax year. In our opinion, it makes no difference what caused the increase or decrease during the year, whether increased by the writing of new business or whether decreased by death of the policyholder, surrender of the policy or conversion from a nonparticipating to a participating contract. We conclude that the opening figure is to be subtracted from the closing figure and the 809(d)(5) deduction applied to the difference, as was decided by the trial court.

XI. CROSS–APPEAL ISSUE NO. 4: LOSSES FOR BAD DEBTS ON ADVANCES TO LIFE INSURANCE AGENTS AS DEDUCTIBLE IN COMPUTING NET INVESTMENT INCOME.

During the years 1961 through 1965, Southwestern charged off as worthless bad debts, advances it had previously made to former life insurance agents no longer employed by the company. These amounts were substantial. Taxpayer claims a deduction of these amounts as for bad debt

losses from gross investment income in determining net investment yield.

The taxpayer found it necessary in engaging life insurance agents to make advances to them until such time as they were producing enough commissions to maintain their standard of living. All income from the taxpayer earned by an agent is represented by commissions based on life insurance business written. The agents continued to receive such advances until such time as their commission exceeded their monthly advances and thereafter the excess over the monthly advance was applied to reduce the balance which had been accumulated. Only one out of three agents continue with the company for more than two years. Therefore many agents terminate their relationship before the entire amount of advances has been recovered by the taxpayer. It is clear from the record that when these advances are originally made they are made as a loan to the agent. The company charges 4 percent interest on the outstanding balances of the advances and sends a letter to the agent each month showing the state of his account. Following the termination of an agent, it is the taxpayer's policy and practice to leave all unpaid advances outstanding until such time as all commissions have been collected and applied to the account. Thereafter, for some period of time, a monthly statement is sent to the agent showing the amount of the unpaid advances and the amount of his commissions, if any. When the taxpayer

has credited an agent's account with all of the commissions to which he is entitled, the agent is so advised in a letter as follows:

> "Since the advances we made to you as an agent for our Company were in the form of a *loan* against your future commissions, we are required by the Internal Revenue Service to report as income to you, in the year in which it charged off, the portion of the indebtedness that was not repaid by the commissions credited to your account. . . ." [Emphasis added.]

With respect to this matter, the trial court made the following findings of fact:

> "[T]he Court finds that in January of the year after all commissions generated by agents who have been disassociated with the company are applied against the balances due from the advances previously made, the taxpayer writes off those balances as bad debts. . . . The Court further finds that it is an industry-wide practice to make these advances to new agents and that it is well understood within the industry that the insurance company will not proceed against agents to collect unrepaid balances following disassociation."

It is without dispute that no effort is made by the company either to ascertain the solvency and ability of such agents to repay to the company the amount of these advances or to collect them. The company does not even demand repayment, but instead merely cancels the amount on the

books and notifies the former agent that it is reporting the cancellation for income tax purposes as though the amounts were being paid as income to the former agent.

From this state of the record, the trial court found that the taxpayer could not take a bad debt loss deduction for these sums in the tax year when the debts were forgiven.

> "The question of the worthlessness of [a] debt . . . is essentially one of fact. The burden rests on the petitioner to establish this fact by a preponderance of the evidence. *Lunsford v. Commissioner of Internal Revenue*, 5th Cir. 1954, 212 F.2d 878."
>
> *Eagle v. Commissioner of Internal Revenue*, 242 F.2d 635 (5th Cir. 1957).

While the trial court did not announce a conclusion in his conclusions of law dealing with the deductibility of these items as bad debts, its judgment in favor of the government of the amounts represented by this issue was tantamount to a finding of fact that the plaintiff taxpayer had failed to meet this standard of proof. The trial court could not have found otherwise. The taxpayer elected to call this advance a loan and treated it as a loan bearing interest at 4 percent. The forgiveness of the amount was also described in the last communication from the company to the agent as a "loan." While it is not required that

legal action to enforce collection be taken to establish worthlessness where there is a factual basis for the finder of facts to determine that a debt is worthless and uncollectible, Treasury Regulations § 1.166-2(b), there is no justification for the theory that a debt can be deducted as worthless under § 166 merely because the creditor elects not to enforce the obligation. *See* for discussion, 5 Mehrten's Law of Federal Income Taxation, § 30.39, pp. 98–99.

Furthermore, there is no more merit in taxpayer's contention as an alternative, if the Court holds that a bad debt deduction is not available, then the advances should be considered as additional compensation to the former agents at the time payments were made. These payments were not intended by the parties to be compensation when the advances were made, but were considered by the parties to be the creation of a debt. To be sure the forgiveness of the debt, at a period considerably later, after termination of employment, did create an obligation on the part of the former agent to report a forgiveness of the debt as income to him at the time it occurred. That is the only year in which the debt was translated into additional compensation to the former agent.

The trial court's judgment against the taxpayer with respect to this item was correct.

XII. CROSS–APPEAL ISSUE NO. 5: ARE (A) DEFERRED AND UNCOLLECTED PREMIUMS ON LIFE INSURANCE AND ANNUITY CONTRACTS (B) "UNEARNED" INTEREST ON POLICY LOANS; (C) ADVANCES TO INSURANCE AGENTS; (D) AMOUNTS DUE FROM REINSURERS; (E) TAXPAYER'S PARTICIPATION INTEREST IN REINSURANCE POOLS; AND (F) THE UNAMORTIZED COST OF INSURANCE POLICIES IN FORCE ACQUIRED FROM ATLANTIC LIFE "ASSETS" OF THE TAXPAYER WITHIN THE MEANING OF § 805(b) OF THE CODE?

In stating this issue, we have utilized the statement from the government's brief rather than that of the cross-appellant, because the taxpayer lumps together under this issue two other items with which we have already treated in this opinion, to-wit: (1) whether accident and health premiums due and unpaid and (2) mortgage escrow funds in amounts held by taxpayer as agent or trustee for others are "assets" within the meaning of § 805(b).

Southwestern makes an underlying argument in its attack on the government's position that these items are to be considered within the definition of "assets" under § 805(b). This argument, briefly put, is that the term "assets" as used in this section was intended to include only those

items of property which actually produced income and were includable as investments under § 804(b), plus money belonging to the company; that items which do not actually contribute to investment income, as this argument goes, arise out of the insurance trade or business, and therefore under the definition section do not belong to the taxpayer or do not constitute property and are excludable from the asset definition. As was the trial court, we remain unconvinced that the legislative history requires a construction of the definition of assets so limited as propounded by the taxpayer. However, we no longer need consider this question, because it has been answered definitively by the Supreme Court in *Commissioner of Internal Revenue v. Standard Life & Accident Insurance Co.* (No. 75–1771), — U.S. ——, 97 S.Ct. 2523, 53 L.Ed.2d 653, dec. June 23, 1977. This follows inevitably from the decision of the Supreme Court which held that the "net valuation" portion of unpaid life insurance premiums must be included in a life insurance company's assets, the issue discussed *infra* under A. It is clear that no part of such unpaid premiums produce any income for the taxpayer, yet the court found them to be assets.

A. *Deferred and Uncollected Premiums.*

As is common in the life insurance industry, taxpayer's policyholders may elect to pay premiums on life insurance and annuity contracts in semi-annual, quarterly or monthly installments. The portions of the gross annual premiums which are not due until after December 31 of each year, and which in fact remain unpaid as of that time, are generally referred to as "deferred" premiums. Furthermore, as a general rule such contracts provide for a grace period during which the policy remains in force notwithstanding the failure of the insured to pay the required premium. At the end of the years in issue, taxpayer had a number of policies in force by virtue of the grace period provision. Premiums owing but uncollected with respect to those policies as of December 31 of each year are normally referred to as "due and unpaid." We refer to these two classifications as "deferred and uncollected" premiums. The method of dealing with these items for tax purposes has been much mooted in the courts, this Court in *Western National Life Insurance Co. of Texas v. Commissioner of Internal Revenue*, 432 F.2d 298 (5th Cir. 1970) having held that since the insurance companies accrued these items in computing their reserves they would have to accrue them for all other purposes, including inclusion as assets under § 805(b)(3). Other Circuits arrived at the same conclusion, *see Jefferson Standard Life Ins. Co. v. United States*, 408 F.2d 842 (C.A.4 1969), *cert. denied* 396 U.S. 828, 90 S.Ct. 77, 24 L.Ed.2d 78; *Western & Southern Life Ins. Co. v. Commissioner of Internal Revenue*, 460

F.2d 8 (6th Cir. 1972), *cert. denied* 409 U.S. 1063, 93 S.Ct. 555, 34 L.Ed.2d 517; *Franklin Life Ins. Co. v. United States*, 399 F.2d 757 (7th Cir. 1968). The Court of Appeals for the Tenth Circuit disagreed, *Standard Life & Accident Ins. Co. v. Commissioner of Internal Revenue*, 525 F.2d 786 (10th Cir. 1976), and created a conflict which has now been resolved by the Supreme Court.

The Supreme Court recognized that the statute which in § 818 provided for the use for computation purposes either of an accrual method of accounting or a combination of an accrual method with any other except cash receipts and disbursements further provided "except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of annual statement approved by the National Association of Insurance Commissioners." The Court then said:

> The legislative history makes it clear that the accounting procedures established by the NAIC apply if they are 'not inconsistent' with accrual accounting rules. (Footnote omitted). In other words, except when the rules of accrual accounting dictate a contrary result NAIC procedures 'shall' apply. (Footnote omitted)." —— U.S. at ——, 97 S.Ct. at 2529.

Commissioner of Internal Revenue v. Standard Life & Accident Ins. Co., supra.

The NAIC procedure as to the treatment of deferred and unpaid premiums is to require the inclusion of the "net valuation" portion of such premiums but not the "loading" portion in the reserves and also in the assets. The "net valuation premium" is that part of the premium determined under mortality and interest assumptions that must be held to assure that the company will have sufficient funds to pay death benefits. The rest of the premium is called "loading" and covers profits and expenses such as salesmen's commissions, state taxes, and overhead.

The trial court's treatment of this item was in accord with our earlier decision in the *Western National Life* case which has now been partially overruled. The final disposition of the amounts involved under this issue can, however, be readily ascertained, since the Court has now mandated the treatment of this item for tax purposes in the same manner as is required to be accounted for in the statement prescribed by NAIC.

B. *"Unearned" Interest on Policy Loans.*

In Part IX, *supra*, we held that the amount charged by the company as interest on policy loans to its policyholders is includable in taxpayer's investment income. In doing so, we rejected taxpayer's argument that such amounts were not truly interest because the policy loans were not real loans.

Taxpayer here argues that such accrual interest is not includable as an asset for the same reason. We reject this argument for the same reason.

We have heretofore held that such interest is to be accounted for as income because such policy loans are to be treated for tax purposes as the "loan" which the company says they are in its dealings with its policyholders.

The trial court therefore correctly held that this item should be included in the § 805(b) assets.

C. *Advances to Insurance Agents; (D) Amounts Due From Reinsurers; (E) Taxpayer's Participation Interest in Reinsurance Pools; and (F) The Unamortized Cost of Insurance Policies in Force Acquired from Atlantic Life.*

Aside from its underlying argument, previously discussed, to the effect that only those assets which produced income are to be included under § 805(b), an argument now foreclosed by *Standard Life, supra*, taxpayer cites no authority for its contention that the trial court erred in its disposition of these four last issues. The amounts representing each of these items, as recognized by the trial court, must be included in assets because of the broad definition of the term used in the statute and

the underlying regulations as interpreted by the courts. *See Jefferson Standard Life Ins. Co. v. United States*, 408 F.2d 842 (4th Cir. 1969) and regulations § 1.805-5(a)(4)(iii), § 1.805-5(a)(4)(i).

The judgment is vacated and the case is remanded to the trial court for further proceedings consistent with this opinion. Each party shall bear its own costs.

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APPENDIX B

Southwestern Life Insurance Company, Plaintiff v. United States of America, Defendant.
Southwestern Life Insurance Company, Plaintiff v. United States of America, Defendant.

U. S. District Court, No. Dist. Tex., Dallas Div., Civil Action Nos. CA-3-3003-D, CA-3-3210-D, 1/29/75.

Findings of Fact and Conclusions of Law

HILL, District Judge: This action was tried before the Court without a jury. After considering the pleadings, stipulations of the parties, testimony, documents admitted, and arguments of counsel, the Court makes and enters its findings of fact and conclusions of law as follows:

Findings of Fact

1. This is an action for recovery of federal income taxes and interest paid by the plaintiff, Southwestern Life Insurance Company (hereinafter referred to as "taxpayer"), for its calendar years 1958 through 1965. Taxpayer is organized and operated as a life insurance company, and was incorporated under the laws of Texas on March 10, 1903, with its offices and principal place of business at Dallas, Texas. Defendant is the United States of America.

2. The taxpayer timely filed its federal income tax return for the year 1958 on Form 1120L, and paid the amount of income tax liability shown to be due thereon of $882,679.88. After examination, the Government assessed a deficiency in the amount of $1,250,137.36 ($1,052,340.58 in tax and assessed interest of $197,796.78), which was paid on November 2, 1962 (the tax), and on December 18, 1962 (the interest). On June 1, 1964, taxpayer filed with the District Director of Internal Revenue a claim for refund in the amount of $1,043,205.16 (tax only; assessed interest with respect thereto was claimed but not specifically computed). This claim for refund has never been denied by the Government, but more than six months has elapsed since its filing.

3. Taxpayer timely filed its federal income tax return for the year 1959 on Form 1120L, and paid the amount of income tax liability shown to be due thereon of $1,217,775.93. Following examination of that return, the Government assessed a deficiency of $1,723,933 ($1,488,886.13 in tax and $235,046.87 in assessed interest). On November 2, 1962, taxpayer paid the deficiency in tax and on December 18 the interest, and on June 1, 1964, it filed with the District Director of Internal Revenue a claim for refund in the amount of $1,310,612.60. (This amount was for assessed tax only. Although taxpayer claimed also assessed interest with respect thereto, it did not compute the amount.) That claim for refund has never been denied by the

Government, but more than six months has elapsed since it was filed. On January 17, 1969, an over-assessment in the amount of $64,644.96 ($55,824.64 in tax and $8,820.32 in interest) was credited to the taxpayer's account with respect to the 1959 assessment.

4. Taxpayer timely filed its federal income tax return for the year 1960 on Form 1120L and paid the amount of income tax liability shown to be due thereon of $1,003,778.38. Following examination, the Government assessed a deficiency in the amount of $1,808,095.18 ($1,612,001.34 in tax and $196,093.84 in assessed interest). These deficiencies were paid on four dates. Tax in the amount of $1,184,726.58 was paid on November 2, 1962. Interest in the amount of $116,064.72 was paid on December 18, 1962. Tax in the amount of $427,274.76 was paid on April 29, 1964, and interest in the amount of $80,029.12 was paid on May 13, 1964. On or about June 1, 1964, taxpayer filed with the District Director of Internal Revenue a claim for refund for the year 1960 in the amount of $1,648,711 ($1,452,617 in tax and $196,094 in assessed interest). Although this claim for refund has never been denied by the Government, more than six months has elapsed since it was filed.

5. Taxpayer timely filed its federal income tax return for the year 1961 on Form 1120L and paid the amount of income tax liability shown to be due thereon of $2,062,774.17. Following examination, the Government assessed a deficiency of

$1,320,748.08 ($1,086,255.61 in tax and $234,492.47 in interest). This amount was paid on March 3, 1969. Taxpayer filed its claim for refund on May 22, 1969, in the amount of $1,320,748 ($1,086,256 in tax and $234,492 in interest). This claim was denied by letter of May 22, 1969.

6. Taxpayer timely filed its federal income tax return for the year 1962 on Form 1120L and paid the amount of income tax liability shown to be due thereon of $2,513,127.66. Following examination, the Government assessed a deficiency of $652,224.65 ($533,606.13 in tax and $118,618.52 in interest). Taxpayer paid the deficiency on March 6, 1969. Taxpayer filed its claim for refund on May 22, 1969, for the full amount of deficiency assessed and collected, which claim was denied by letter of that same date.

7. Taxpayer timely filed its federal income tax return for the year 1963 on Form 1120L and paid the amount of income tax liability shown to be due thereon of $2,604,701.66. After examination, the Government assessed a deficiency in the amount of $815,120.11 ($631,715.06 in tax and $183,405.05 in interest), which was paid by taxpayer March 6, 1969. On May 22, 1969, taxpayer filed with the District Director of Internal Revenue a claim for refund for the year 1963 in the total amount of the deficiency. This claim was denied by letter of May 22, 1969.

8. Taxpayer timely filed its federal income tax return for the year 1964 on Form

1120L and paid the amount of income tax liability shown to be due thereon of $2,366,322.94. Following examination of the tax return, the Commissioner of Internal Revenue assessed a deficiency of $557,109.83 ($452,813.79 in tax and $104,296.04 in interest), which was paid by taxpayer on March 6, 1969. On May 22, 1969, taxpayer filed with the District Director of Internal Revenue a claim for refund for the year 1964 in the full amount of the deficiency assessed. That claim was denied by letter of May 22, 1969.

9. Taxpayer timely filed its federal income tax return for the year 1965 on Form 1120L and paid the amount of income tax liability shown to be due thereon of $2,714,064.13. Following examination, the Government assessed a deficiency of $454,075.75 ($387,989.91 in tax and $66,085.84 in assessed interest). This amount was paid by taxpayer on March 3, 1969. On May 22, 1969, taxpayer filed a claim for refund of the entire amount of deficiency, which was denied by letter of that same date.

10. The total amount in issue in this lawsuit raised by taxpayer's claims for refund is $8,579,563. However, taxpayer's claims for refund do not make any reference to one issue now sought to be raised by it for the years 1958 through 1960. This issue concerns whether unearned interest on policy loans should be included in computing net investment income under Section 804(c) of the Internal Revenue Code

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Year	Amount of Reserves Beginning	End	Mean	Required Interest	Deduction for Increase in Reserves
1960					
Life Res.	$2,833,303	$2,975,280	$2,904,291	$ 87,129	$141,977
Pen. Plans	87,627	103,923	95,775	2,872	16,296
1961					
Life Res.	3,029,576	3,124,662	3,077,119	92,314	95,086
Pen. Plans	142,543	243,898	193,220	5,797	101,355
1962					
Life Res.	3,124,662	3,808,260	3,466,461	103,994	683,598
Pen. Plans	243,898	38,929	141,414	4,242	(204,969)
1963					
Life Res.	3,808,260	4,107,438	3,957,849	118,735	299,178
Pen. Plans	38,929	45,444	42,186	1,266	6,515
1964					
Life Res.	4,107,438	4,434,440	4,270,939	128,128	327,002
Pen. Plans	45,444	44,396	44,920	1,348	(1,048)
1965					
Life Res.	4,434,440	4,215,648	4,325,044	129,751	(218,792)
Pen. Plans	44,396	41,575	42,985	1,290	(2,821)

The parties now agree that:

(a) This reserve is a life insurance reserve as that term is defined by Section 801(b).

(b) The reserve as established for all first-year policies is fully deductible, and should be included in the reserve computation in the year the policy is issued.

(c) With regard to the initial establishment of the reserve for immediate payment of death claims on all other policies than new policies, the deduction for the increase

or 1954. (All statutory references hereinafter will be to the Internal Revenue Code of 1954 unless otherwise specifically identified.) Taxpayer admits that this issue was not raised by its claims for refund for the years 1958, 1959, and 1960. Accordingly, this Court does not have jurisdiction to consider this issue.

11. This case involves over twenty substantive issues, of which the parties have agreed on some eight. Five of the agreements are in the nature of absolute concessions by the parties, while the other three of the agreements are limited to the extent that judicial authority in the Fifth Circuit will govern the consequences of this lawsuit. These eight agreed issues are summarized in the eight succeeding paragraphs.

12. The first of these issues deals with the reserve for immediate payment of death claims established and maintained by taxpayer as a life insurance reserve under Section 801(b) and disallowed by the Government for the years 1960 through 1965. The amounts in issue are as follows:

in reserves attributable to prior taxable periods must be spread equally over a 10-year period commencing the year after the initial establishment of the reserve in 1959.

13. During the year 1961, taxpayer established and maintained a reserve for disability benefits on active lives as follows:

Reserves at beginning of year	Reserves at end of year
$2,086,401	$2,208,885

Mean Reserves	Required Interest at 3½ percent
$2,147,643	$75,167.50

The Government now concedes with respect to all years following 1961 that the disability benefit on active life reserve is a life insurance reserve under Section 801(b), but with respect to the year 1961 the Government contends and taxpayer concedes that the reserve does not comply with the requirements of Section 801(b); to the extent that the 1961 reserve does not comply with 801(b), it must be excluded from the reserve computations.

14. With respect to taxpayer's claimed reserves for resisted and unreported claims, the Government is willing to allow reserves to be maintained upon the basis of taxpayer's historical experience with respect to actual payouts of such resisted and unreported claims, but the taxpayer does not wish to introduce any evidence with respect to this issue; therefore, taxpayer having

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failed in carrying its burden of proof with respect to this issue, no recovery is allowable.

15. With respect to the issue of whether or not taxpayer is entitled to a deduction for the increase in loading on deferred and uncollectible premiums, taxpayer concedes the issue.

16. Certain of the items contained within plaintiff's Exhibit D, remittances and unallocated items, are duplications of assets already included in the computation. Others of the items are not duplications and must be included in the computation of assets. The parties are agreed on which of those items reflected in plaintiff's Exhibit D are duplications and which are not and are also agreed that amounts listed as "Totals—Suspense accounts which cause duplication of assets" on the plaintiff's Exhibit D are the amounts which are to be excluded from assets for each of the years involved, and no further finding by this Court is required.

[*Issues Settled By Precedent*]

17. The issue of whether or not life insurance and annuity premiums deferred and uncollected (net) must be included in assets has been decided by the United States Court of Appeals for the Fifth Circuit in *Western National Life Insurance Co. v. Commissioner* [70-2 USTC ¶ 9625], 432 F. 2d 298 (1970), and although taxpayer does not desire to concede the issue, both parties agree that this Court should decide the

issue in accordance with the Fifth Circuit's opinion therein. That being the case, this Court finds that the amount of life insurance and annuity premiums deferred and uncollected (net) must be included in computation of assets for phase I and phase II purposes.

18. The issue of whether the amount of loading on life insurance and annuity premiums deferred and uncollected must be included in assets has previously been decided by the United States Court of Appeals for the Fifth Circuit in *Western National Life Insurance Co. v. Commissioner, supra.* Although taxpayer does not desire to concede the issue, both parties agree that this Court should decide the issue in accordance with the Fifth Circuit's opinion therein. That being the case, this Court finds that the amount of loading on life insurance and annuity premiums deferred and uncollected must be included in computation for assets for Phase I and Phase II.

19. The issue of whether or not mortgage escrow funds held in trust by taxpayer must be included in assets has previously been decided by the United States Court of Appeals for the Fifth Circuit in *Liberty National Life Insurance Co. v. Commissioner,* 463 F. 2d 1027 (1972). Although the Government does not desire to concede the issue, both parties agree that this Court should decide the issue in accordance with the Fifth Circuit's opinion.

[*Other "Asset" Issues*]

20. Of the remaining fifteen unagreed issues, seven deal with the question of whether various accounts must be included by taxpayer in its computation of "assets" under Section 805(b)(4). The issue with each of these separate accounts is generally the same: whether the item involved constitutes an asset of the taxpayer other than real and personal property (excluding money) used by it in carrying on its insurance trade or business. Two unagreed issues involve the question of the proper computation of reserves maintained by taxpayer and additions to reserves on an annual basis. Finally, six unagreed issues involve generally the various income and deductions proper in computing taxpayer investment and operating income under Phase I and Phase II of the taxation of life insurance companies section of the Internal Revenue Code—Subchapter L.

21. Concentrating first on the asset issues, the amount of assets in dispute for each of the years 1958 through 1965 for each of the several categories upon which the parties are not agreed is as follows:

		1958	1959	1960	1961	1962	1963	1964	1965
(1)	Due and unpaid accident and health premiums	$ 37,499.71	$ 46,011.53	$ 65,457.40	$ 161,404.71	$ 230,491.15	$ 239,020.46	$ 338,779.45	$ 606,239.15
(2)	Agents' debit balances	357,984.56	356,529.03	358,430.77	794,809.13	594,110.48	708,256.48	805,042.46	888,855.43
(3)	Remittances and unallocated items	416,551.46	279,161.09	144,409.38	66,303.92	676,302.24	1,242,107.31	1,092,188.65	2,228,246.36
(4)	Amounts held as trustee or agent (primarily payroll taxes)	.....	.....	.....	272,603.38	1,299,253.37	1,497,153.84	1,378,435.99	1,463,873.89
(5)	Participation in insurance plans:								
	FEGLI	28,631.88	29,451.64	32,610.85	34,309.95	45,440.51	47,489.20	51,537.24	56,027.36
	65 health plans	.....	.....	.....	.....	.....	11,738.52	66,547.21	81,566.87
	Reinsurance with Lincoln National	.....	.....	.....	1,410.00	3,933.00	3,567.96	3,342.75	2,707.39
(6)	Amounts recoverable from reinsurers	20,535.00	90,910.00	135,527.00	74,095.30	80,537.98	100.00	2,978.67	4,383.05
(7)	Unamortized portion of capitalized cost of insurance purchase (Atlantic Life)	.....	.....	.....	8,783,603.00	7,850,014.00	6,926,482.00	5,994,837.00	5,063,191.00
(8)	Unearned interest on policy loans	.....	.....	.....	1,269,472.00	1,254,238.00	1,293,380.00	1,344,913.00	1,447,967.00

22 Taxpayer follows the industry-wide practice of allotting monies to its new agents in excess of their commissions earned for a period of time as they become established as insurance agents. These monies are necessary to the insurance agents because, typically, a new agent will not be able to sell enough insurance upon which commissions are earned to support himself and his family until he becomes established in the business. If the agent stays with the company, it is expected that his commissions will eventually reach the point where his family can subsist upon them rather than the amounts which were allotted to him by the company while he was becoming established as an insurance salesman. To the extent that his commissions earned increase, the balance of amounts allotted by the company in earlier times will be deducted on a ratable basis. Eventually it is expected with permanent agents of the taxpayer that the balances of amounts allotted by the company during the agent's initial period will be repaid to the company out of the commissions earned by the agent following the initial period. The periodic statements which each agent receives indicate that the amounts advanced to the agent are personal liabilities of the agent.

In some circumstances, the agents become disassociated with the company prior to the time that their commissions have been sufficient to cover the balances allotted to them. After the taxpayer has applied all earned commissions generated by a disassociated

agent against the amounts advanced to him, the taxpayer claims that it is entitled to write off the remaining unrepaid balances as a bad debt. Prior to that time, however, the parties are not in agreement as to the proper treatment of these balances in computing assets under Section 805(b)(4). Taxpayer claims that these balances should be excluded from computation of assets because, while admittedly assets, they are used in its insurance trade or business. The Government, on the other hand, contends that these assets are not utilized in the insurance trade or business. This Court finds that the agents' balances are not insurance trade or business assets such as those listed and enumerated in Treasury Regulations on Income Tax, Section 1.805-5(a)(4)(i), which generally include the home office of the company, including buildings and land, furniture and equipment utilized in carrying on its life insurance business, supplies and printed matter utilized in carrying on its life insurance business, and automobiles and other depreciable personal property utilized in carrying on its life insurance business. Rather, the agents' balances are accounts receivable, and must be included in the computation of assets.

23. In common with most insurance companies, taxpayer reinsures many of the policies which it writes with other life insurance companies. Commonly, when a claim for payment on a policy which the taxpayer has written is made, and that policy is subject to a reinsurance agreement with another company, taxpayer will in turn make a

claim upon that other company. However, a time lag between the date the claim is made upon the other company and payment of that claim invariably occurs. During the period between which a claim is made and the time in which it is satisfied, the amounts due from reinsurers constitute an asset of the taxpayer which is not of that type enumerated in Treasury Regulations on Income Tax, Section 1.805-5(a)(4)(i). Accordingly, the amounts due from reinsurers do not constitute an asset utilized in taxpayer's insurance trade or business and are to be included in assets under Section 805(b)(4). With respect to the amounts recoverable from reinsurers, plaintiff keeps its books on a cash receipts and disbursements method rather than the mandatory accrual accounting method of Section 818(a). That is, it awaits the receipt of cash from reinsurers before reflecting these accounts receivable on its books and records. The recovery of these amounts from reinsurers is not subject to dispute and is a routine matter only.

24. Plaintiff engages in a number of joint insurance plans with other companies. Among these plans are Federal Employees Group Life Insurance (FEGLI) and other plans known as the Lincoln National Reinsurance Plan and the 65 Health Plan. In each of these plans the plaintiff contributes to a central pool administered by an insurance company for the purpose of insuring substandard risks. The assets of these pools are invested in income producing properties, the return on which is utilized to defray

claims made on the pools under the various programs. Each year an accounting is rendered to plaintiff and the other companies participating in the pools of the current status of them. As claims are made on the pools they are reduced until, after a period of time, the excess, if any, is refunded to plaintiff and the other companies. These pools operate much as plaintiff's regular life insurance reserves which are backed up by invested assets. As claims are made on insurance contracts, the assets must be liquidated in order to meet the contractual requirements and life insurance reserves are consequently reduced. At any one time, however, plaintiff's interest in the various pools is measurable and is equivalent to the total invested assets of those pools less claims and administrative expenses. These pools do not constitute one of those items which make up assets used in plaintiff's life insurance trade or business.

25. At the end of taxpayer's annual accounting year, a number of payments are received by it which cannot be physically segregated into the proper accounts until after the end of the year. Typically, these payments would relate to mortgage payments received from mortgage service agents which cover a number of different loans and which are impossible to segregate immediately, and premium payments on which the premium notice stub or policy number is absent. In both cases, the payments are placed into suspense accounts by taxpayer and cash and checks are deposited in the taxpayer's bank account. On the other hand, certain of the

unallocated items do not fall into that category: Rather, these are amounts maintained by taxpayer in its remittances—unallocated items accounts which do not duplicate any other asset account. Typically, these include an account for repairs, foreclosure expenses, cash with applications for insurance, and a deferred group (vested retirement benefits) account. The true suspense accounts are duplications of already-included assets, primarily mortgage loans receivable and deferred and uncollected premiums. To the extent that a portion of the remittances and unallocated items constitute duplications of other asset accounts, they should be excluded from a computation of assets under Section 804(b)(4). To the extent that the remittances and unallocated items do not constitute duplications of other assets, they should be included in computation of assets.

26. From time to time, the taxpayer made loans to its policyholders, the maximum principal amounts of which were typically determined by the cash values of the policies involved. Under the express terms of taxpayer's policy loan agreements with borrowers, interest was paid in advance to the end of the policy year, and annually thereafter on the policy anniversary date for the ensuing year. Interest which was not paid when it was due was added to the principal of the existing loan. The whole or any part of the indebtedness arising from a policy loan could be repaid

at any time; if repayment of a policy loan was made during the policy year, the exact amount of interest rateably earned by the taxpayer was retained by it, with the residue returned to the policyholder. If the policyholder should surrender his policy for the cash value, then only the exact amount of prepaid interest rateably earned was retained by the taxpayer, and the residue was returned to the policyholder; and if the policyholder should die, then only the exact amount of prepaid interest rateably earned was retained by the taxpayer, and the residue was paid to the beneficiary of the policy. Unpaid interest added to principal when it was not actually paid was similarly retained or returned on the basis of whether it was rateably earned. Although the provisions of Section 818(a) expressly require that computation of life insurance company income taxes shall be made under an accrual method of accounting, taxpayer reported only such interest income or assets as it rateably earned. Whether by means of prepayment at the time of its making a policy loan, or by means of capitalizing advance interest in succeeding years, the taxpayer accrued and received interest at the time of prepayment or capitalization. The parties differ as to the treatment of the accrued but unearned interest for purposes of inclusion into assets under Section 804(a)(4), and determination of investment income under Section 809(a). The amounts of adjustment in issue (1961 through 1965 only) are as follows:

1961	$ 59,807
1962	44,766
1963	39,142
1964	51,533
1965	103,054

Of the 14,000 policy loans in existence during a representative year at issue, there were only 200 cases in which the loans were prepaid and some adjustment to prepaid interest was made by the taxpayer.

[*Interest Paid*]

27. In computing the amount of "Interest Paid" under Section 805(e) for determining the amount of "Policy and Other Contract Liability Requirements", the taxpayer included herein amounts it paid as excess interest on certain insurance policies issued to qualified pension plans. The Government decreased the amount of "Interest Paid" for each of the years in the amount of the taxpayer's payments for excess interest and has reclassified the payments as policy dividends as follows:

Interest Paid Decreased

Year	Amount
1958	$ 5,195.90
1959	1,972.42
1960	288,414.97
1961	282,793.59
1962	543,594.00
1963	738,627.29
1964	816,917.72
1965	770,356.22

The adjustment for claimed excess interest results from payments made by the

taxpayer to qualified pension plans which have purchased certain contracts. Under state law, the maximum interest rate the taxpayer can use in determining the reserves for these contracts is 3½%. Taxpayer enters into an agreement with the pension plans that it will pay directly to the plans an amount in excess of the 3½% interest rate used in computing the reserves.

Taxpayer developed what it calls the "excess interest formula" by which each pension fund is allowed a return on its invested funds in excess of the rate stipulated in the contract. The excess interest formula operates in the following manner:

(a) Taxpayer determines what is known as the investment generation of new money approach. Taxpayer is continuously placing funds into income producing investments. Each year it determines the investment yield in terms of a percentage rate of return on funds invested during the course of the year. This percentage rate is referred to as the new money interest factor.

(b) Taxpayer reduces the new money interest factor by ½ of 1% as a management fee.

(c) The new money interest factor (after reduction for management fee) is then reduced by the amount of guaranteed interest in the policy. Thus, for example, if the new money factor was 4¼% and the guaranteed interest rate was 3½%, the excess interest rate is 1¼%. The excess interest rate is then

multiplied by the current mean reserve of the policies still in force and this is the amount of excess interest.

(d) From the amount of excess interest, there is charged a calculation fee of excess interest, there is charged a calculation fee of $100 plus 5¢ for each policy in force; the net amount constitutes the amount which is actually paid by taxpayer to the pension plan.

An example of how a calculation is made is shown by the following illustration. Assume a plan acquired an annuity contract in 1960 and seven original participants are still covered by the plan. To determine the amount of excess interest to be paid for the year 1965, the calculation is as follows:

Year of Issue	No. of Policies Issued & In Force	New Money Interest Factors	Guaranteed Valuation Interest Rate
1960.....	7	.0464	.0300
1961.....	1	.0460	.0300
1962.....	1	.0455	.0300
1963.....	2	.0451	.0350
1964.....	0	.0449	.0350

Excess Interest Rate Col. 3—Col. 4	Current Mean Reserve of Policies Still In Force	Excess Interest Col. 5 × Col. 16
.0164	$10,000	$164.00
.0160	600	9.60
.0155	400	6.20
.0101	900	9.09
.0099	0	.00
		$188.89
Less: Calculation charge of $100 plus (11 × 5¢)...		100.55
Excess Interest Paid.....		$ 88.34

Taxpayer's excess interest formula generates excess interest payments only from taxpayer's investment earnings and the formula does not contemplate or consider any element of mortality, morbidity or expense savings. The amounts paid as excess interest do not involve at the time of their accrual life, health or accident contigencies.

The contracts which taxpayer issues on which excess interest is paid are (a) the pension trust annuity contracts, (b) the group permanent annuity contracts, (c) the pension trust life contracts and (d) the group permanent life contract.

All reserve requirements for the annuity contracts and life contracts are computed at the time the policies are issued and the reserves for these contracts, at the time they are computed, involve life, health and accident contigencies.

28. The accident and health insurance policies written by taxpayer contain a 31-day grace period following the due dates of the premium. This means that taxpayer is bound to continue a policy in effect for 31 days after the premium becomes due although it has no legal right to force collection of the premium then due. On December 31 of any year, taxpayer has a number of policies in the grace period and continues to carry the policies on its books and shows the amount of premiums unpaid as "Due and Uncollected Premiums."

Uncollected or due and unpaid premiums on accident and health policies, as those

terms are used in the insurance industry, mean those premiums payable on policies under the insured's selected mode of payment where the premiums have not been collected but the policies are carried on taxpayer's books as being in full force. If a premium is due in December, the unpaid portion of the premium for the policy which was due in December is carried as due and uncollected as of December 31.

Taxpayer has no legal enforceable right to collect due and unpaid premiums on its policies, as premiums which have not actually been paid to taxpayer are not contractually due from its policyholders. The provision for the payment of premiums does not afford a cause of action to taxpayer to collect from its policyholders because the payment of premiums is at the sole election of the insured who may decide to keep his policy in force by payment of premiums within the grace period, or elect to abandon or otherwise permit his policy to lapse by non-payment of premiums.

No life insurance reserves are maintained or established as a result of the due and uncollected premiums on accident and health policies. Therefore, they differ from deferred and uncollected premiums on life insurance contracts.

Due and uncollected premiums on accident and health policies are not property since taxpayer has no legal right to make collection.

29. In connection with servicing its mortgage loans, either by the company or

through mortgage servicing agents, certain amounts are collected from the mortgagors each month for the purpose of paying insurance premiums and ad valorem taxes on the mortgaged property when they become due. These funds are generally referred to as mortgage escrow funds. Taxpayer holds these funds in trust for the mortgagors and, therefore, said funds are not assets of nor belong to the taxpayer.

30. Taxpayer, either by law or contractual agreement, is required to retain certain amounts as trustee or agent for the payee or third party. Generally, these amounts consist of withheld taxes due to Federal, State or City governments. The amounts so held by taxpayer as trustee or agent for others do not represent assets of taxpayer.

[*Deductions*]

31. There remain two issues dealing with proper computation of reserves to be settled by the Court. The first of these deals with whether or not beginning reserves of certain nonparticipating contracts may be excluded from computation of additions to reserves under Section 809(d)(5) by taxpayer. Taxpayer issues contracts which are not participating as to dividends as part of its normal business. Many of these contracts provide that upon a certain policy date the contract of insurance will become participating. Typically this might be on the 20th policy anniversary. In computing the additions to reserves for purposes of the special deduction allowed nonparticipating contracts pursuant to Section 809(d), the parties differ as to the proper treatment of reserves maintained with respect to the nonparticipating contracts which became participating during the policy years in question. The taxpayer maintains that when it computed allowable additions to reserves for purposes of the special deduction of Section 809(d)(5) it was entitled to exclude from beginning balances of the reserves the beginning balances of all nonparticipating contracts which became participating during taxpayer's annual period. Because the allowable additions to reserves are computed by deducting the beginning balances from the ending balances, any reduction in the beginning balances results in a larger addition to reserves, and therefore a larger Section 809(d)(5) special deduction. The Government, on the other hand, maintains that there is no statutory or regulatory authority for excluding the beginning balances of nonparticipating contracts which become participating during the year in calculating the amount of allowable additions to reserves.

32. During the year 1957, taxpayer became licensed to sell insurance in the State of California. After it had filed its 1957 annual statement in 1958, the State of California required taxpayer to change its method of computing reserves for certain non-participating life insurance contracts. The following schedule sets forth the details of the change in the method of computing reserves:

Description of Valuation Class	Method Changed From	Method Changed To	Increase In Actuarial Reserve Dut to Change
Life Insurance—ordinary	C. S. O. 3% M. P. T.	C. S. O. 3% C. R. V. M.	$406,695
Life Insurance—ordinary	A. E. 3% M. P. T.	A. E. 3% Ill. Std.	311,971
Life Insurance—ordinary	A. E. 3½% M. P. T.	A. E. 3½% Ill. Std.	101,402
Total:			$820,068

Taxpayer in computing its special deduction on its 1958 income tax return for ten per cent of the increase in reserves on nonparticipating contracts under Section 809(d)(5) included the full amount of the increase in reserve resulting from the change in the method of computation.

On initial examination of taxpayer's 1958 tax return, the Examining Agent took the position that the reserve strengthening occurred in 1957 and not in 1958. Taxpayer paid the tax and timely filed a claim for refund listing the adjustment on Rider 8. This adjustment was listed as erroneously having been determined by the Agent as occurring in 1957 rather than 1958. On examination of taxpayer's claim for refund, the Examining Agent changed his position and recognized the reserve strengthening as occurring in 1958 but reduced the amount of increase in reserve on which the Section 809(d)(5) deduction was based by the amount of $820,068. The Government has allowed a ratable deduction over a ten year period commencing in 1959.

[*Remaining Issues*]

33. The final area for this Court to decide deals with income and deduction issues for both phase I and phase II, and consists of six nonagreed issues. The facts concerning three of these issues have already been set out in previous paragraphs because the items involved are also involved in computing assets under Section 805(b)(4). The first of these three issues concerns whether

unearned but accrued interest on policy loans must be included in investment income for purposes of Section 809(a). For a full discussion of the facts on this issue, see paragraph 26 above. The taxpayer maintains that it is entitled to exclude unearned but accrued interest from computation in investment income, while the Government maintains that it must include that interest in computing its investment income for Section 809(a) purposes.

34. The second of these issues that has been referred to previously is whether the taxpayer may deduct the uncollectible balances of amounts allotted to beginning agents in determining net investment yield under Section 804(c). Taxpayer maintains that it is entitled to deduct these balances in the year in which it chooses to write them off as bad debts in determining a Phase I adjustment, net investment yield. The Government, on the other hand, denies that a taxpayer is entitled to write these sums off as bad debts, but has allowed a deduction under Section 809(a) for Phase II purposes in computing operating income. This issue was previously treated in the assets portion of these findings in paragraph 22. In addition to those findings, the Court finds that in January of the year after all commissions generated by agents who have been disassociated with the company are applied against the balances due from the advances previously made, the taxpayer writes off those balances as bad debts. It does so without regard to any

determination as to the financial ability of the ex-agents to repay the amounts which have been advanced to them, and without any effort to collect those amounts through court proceedings, through hiring of collection agents, or even through dunning letters and the other procedures ordinarily resorted to by creditors to collect debts. The Court does find that in some cases efforts are made to collect as a punitive step to deter ex-agents from pirating away business developed while associated with taxpayer. The Court further finds that it is an industry-wide practice to make these advances to new agents and that it is well-understood within the industry that the insurance company will not proceed against agents to collect unrepaid balances following disassociation.

35. Taxpayer, as part of its investment program, began purchasing oil payments during the year 1959. In these transactions, taxpayer, for a specified sum, purchased oil production until such time as it had recovered the amount of its costs, plus an amount known as an "interest equivalent element" which was applied at a specified rate on the amount of unrecovered costs. Taxpayer's investment and the return thereon were recovered solely from oil production. Prior to January 1, 1964, the taxpayer had computed its allowable cost depletion under that method known as "declining balance." Sometime during 1963 there was a change in the taxpayer's personnel in charge of calculating oil payments and associated matters. The new person in charge decided

that it would be more advantageous to switch to a different method of computing allowable depletion, the "sum of the dollars" method which he proceeded to do. Following that corporate decision, the Treasury promulgated a Technical Information Release in late 1964 allowing computation of depletion under either the declining balance or sum of the dollars method. However, the taxpayer's decision to change was made prior to the promulgation of that T. I. R. and could not have been in reliance upon it. In addition to computing depletion on its newly acquired oil payments under the sum of the dollars depletion method, the taxpayer, on an ex post facto basis, changed its method of calculating depletion on all amounts received subsequent to 1958 to the sum of the dollars method. The additional depletion deductions claimed by virtue of that change are as follows:

Year	Depletion Deduction in Issue
1959	$ 26,743
1960	83,616
1961	117,611
1962	165,802
1963	198,965
1964	248,895
1965	244,925
Total	$1,086,557

The difference in dollar amounts set out above reflects that the two methods of cost depletion produced differing amounts of cost depletion deductions over different periods of time and constitute different accounting methods. Taxpayer at no time either

requested or received consent of the Secretary of the Treasury or his delegate in effecting the change in accounting method. Under this set of facts, the taxpayer contends that it was entitled to change its method of computing cost depletion on existing oil payments because it would not have been allowed by the Internal Revenue Service to compute cost depletion on the sum of the dollars method prior to the promulgation of the T. I. R. in question, and that it was unfair to require the taxpayer to secure the permission of the Secretary of the Treasury or his delegate prior to changing the method of computing cost depletion. The Government, on the other hand, maintains that (1) the sum of the dollars method in computing cost depletion was not forbidden prior to promulgation of the T. I. R. in question; (2) taxpayer effected the change in computing cost depletion prior to promulgation of the T. I. R. and not in reliance upon it; and (3) in no event is taxpayer entitled to change its method of computing depletion even from an impermissible to a permissible method without the consent of the Secretary of the Treasury or his delegate.

36. The next issue to be considered by this Court deals with of this item is in the computation. The taxpayer utilized a two-step method, claiming bad debt losses for the gross amount suffered, and then short-term gains for the insurance recoveries; the Government lumped insurance recoveries against the gross loss in determining the

net allowable losses. For the years in issue (1961 through 1965 only), the amounts of bad debts losses denied in issue are as follows:

Year	Amount of bad debt reduction (and reduction of short-term capital gain)
1961	$220,139
1962	180,653
1963	223,137
1964	226,243
1965	295,467

Taxpayer maintains that Treasury Regulations on Income Tax, Section 1.166-6, do not provide for inclusion of insurance recoveries in computing bad debts upon mortgage foreclosures. It is the Government's contention that Section 166 allows deduction of bad debts only after insurance or other recoveries on the bad debts are included in the computation, and any failure to include insurance recoveries in measuring a bad debt would be in error.

37. Two final issues to be determined by the Court concern whether the excess of the purchase price paid for assets received over their fair market value in acquiring all of the life insurance in force of another life insurance company is deductible in the year of payment and whether, in determining the amount of policy and other contract liability requirements, excess of purchase price over fair market value of assets received less amortization allowed should be included in assets under Section 805(b)(4).

38. In 1961 taxpayer purchased the stock of the Atlantic Life Insurance Company from its shareholder, Life Companies, Inc. This the method utilized by taxpayer in computing its allowable bad debt expenses

arising out of foreclosure of mortgages insured by the Veterans Administration and Federal Housing Administration. Taxpayer in its business as a life insurance company invests money in numerous mortgage loans, many of which are insured, in turn, by the FHA or VA. When default is made on one of these loans, taxpayer commonly instructs the trustee to bid the property in at or below the balance of the loan plus certain associated costs such as attorneys' fees and the like. The differences between this total loan balance and fees and the amount for which the property is bid is recorded on the books of taxpayer and claimed by it as a bad debt loss. Following the time in which the property is deeded by the trustee to taxpayer, it, in turn, makes a claim upon the VA or FHA, as the case may be, for proceeds pursuant to their guarantees of insurance. These are typically paid to taxpayer in the form of bonds which are recorded by it upon its books at the fair market value thereof. Taxpayer then reported the fair market value of these bonds as, typically, short-term capital gain. These capital gains, in turn, were utilized during the years in question to wipe out certain long-term capital losses incurred by taxpayer which are not related to this issue. Thus, taxpayer was able to claim bad debt losses which had a tax benefit at the maximum ordinary corporate rate upon which tax was imposed, while the short-term capital gains reported by taxpayer upon receipt of the VA and FHA bonds were essentially taxed at long-term capital gains rates. The Government, in its deficiency notice, dis-

allowed taxpayer's claimed bad debt losses by an amount equal to that which it received from the VA and FHA bonds. As a concomitant, the Government also reduced taxpayer's short-term capital gains which it had reported by an equal amount. Thus, the difference in the parties' treatment transaction was pursuant to a plan of liquidation of Atlantic into taxpayer pursuant to the provisions of Sections 332 and 334 (b)(2) of the Internal Revenue Code of 1954. The plan was consummated and Atlantic was liquidated as of June 30, 1961, with the consideration paid allocated to the various assets based upon their fair market value.

39. The consideration for the transaction was $128,226.890 paid in cash and through assumption of liabilities as follows:

Cash Bonus	$ 29,000,000
Reserve Requirements Assumed	94,536,860
Other Liabilities Assumed.....	4,690,036
Total Consideration Paid	$128,226,896

In exchange for this consideration, the taxpayer received assets having a fair market value of $118,798,778, leaving an excess of $9,864,131 which it denominated as "insurance in force." The complete schedule of assets was introduced as joint Exhibit 38.

40. The reason taxpayer was willing to pay $9,864,131 more than the fair market value of the assets it received was its expectation of profiting from insurance contracts which had already been written by Atlantic. Generally, an insurance company is willing to pay a premium or bonus for insurance

contracts in force because most of the expenses of writing such contracts occur in the first policy year; in succeeding years there is a higher profit margin than that which is ordinarily reflected on the books of an insurance company. Taxpayer's negotiators had estimated the potential value of acquiring Atlantic's insurance contracts in force and were willing to pay the $9,864,131 bonus to acquire the contracts for that reason. Charles Connally, one of taxpayer's negotiators, testified that the excess purchase price represented this intangible benefit of the insurance in force.

41. Mr. Connally testified that these benefits lasted for the life of those policies which was between 5 and 15 years for the various types of insurance involved. No testimony was adduced by the taxpayer which would allow this Court to specifically identify the various types of insurance acquired and to assign specific useful lives to each type. The Government allowed taxpayer to amortize the bonus over the average life of the policies which it reckoned to be ten years. The taxpayer, in contrast, has claimed the right to deduct the entire bonus in the year of its expenditure, 1961.

42. The Government required taxpayer to include in the calculation of assets under Section 805(b)(4) the unamortized portion of the bonus. Taxpayer's primary position is that it was entitled to deduct the bonus in 1961; therefore, there would be no unamortized portion to be included in assets in any circumstance. Its secondary position

is that the unamortized portion of the bonus should not be included in assets in any event.

43. The Government allowed a tax deduction under Section 809(d)(7) in the year of the transaction for the increase in total reserves for the life insurance and other reserves which included the increase in the end of 1961 attributable to reserves assumed by taxpayer in connection with the transaction. The Government required taxpayer to report as income in the year of the transaction the fair market value of the assets (other than the "bonus") which it received in connection with the transaction. The only question properly before this Court raised by taxpayer's claim for refund, the pleadings, and the pretrial order is whether "the excess price paid over the assets obtained is the cost of acquiring life insurance which is deductible in the year incurred * * *." (Pretrial Order IV, par. 8.)

44. Any conclusion of law deemed as properly constituting a finding of fact is hereby adopted as a finding of fact.

Conclusions of Law

1. This Court has jurisdiction of the subject matter pursuant to 28 U. S. C. § 1346, and of the parties except for the issue concerning whether accrued but unearned interest must be included in investment income for the years 1958 through 1960. With respect to that issue it was not included in taxpayer's claims for refund for the respective periods and thus the

Court has no jurisdiction to award any recovery. With respect to the issue of spreading the California required strengthened reserves upon which the Government has raised the question of subject matter jurisdiction, this Court concludes it does have jurisdiction.

[*Issues Settled by Precedent*]

2. This Court in its findings, paragraphs 12 through 19, set out the various agreements of the parties with respect to some eight issues upon which there is no controversy. This Court concludes that the parties' agreements with respect to issues concerning the reserve for immediate payment of death claims, reserve for disability benefits, deduction for increase in loading on deferred and uncollectible premiums, and inclusion of remittances and unallocated items are all in accordance with law, and thereby adopts the parties' positions with respect to the issue concerning reserves for resisted and unreported claims, this Court concludes that taxpayer has failed in his burden of proof, and that, therefore, no recovery with respect thereto is allowable. This Court having found that the parties agreed that the decisions of the Fifth Circuit Court of Appeals in *Western National Life Insurance Co. of Texas v. Commissioner* [70-2 USTC ¶ 9625], 432 F. 2d 298 (1970), and *Liberty National Life Insurance Co. v. Commissioner*, 463 F. 2d 1027 (1972), control the issues of whether deferred and uncol-

lected premiums, including loading, and mortgage escrow amounts are includable in assets, respectively, this Court concludes that it is indeed bound by those decisions and so holds. Accordingly, amounts denominated as deferred and uncollected premiums and the loading with respect thereto must be included in computations of assets from phases I and II and amounts reflecting mortgage escrow funds held by taxpayer and by its mortgage service agents must be excluded from computation of assets for phases I and II.

[*Other "Asset" Issues*]

3. In the remaining issues dealing with computation of assets, certain common principles apply. Definition of the term "assets" as utilized in the Life Insurance Company Taxation Act is governed by Section 805 (b)(4), and lawfully enacted Regulations thereunder. In order to be included in an asset, an item must consist of an asset of the taxpayer (including non-admitted assets) other than real and personal property (excluding money) used by it in carrying on an insurance trade or business. Thus, three issues may be presented in any consideration of whether or not a given item constitutes an asset. In the first place, the question arises over whether or not an item is indeed an asset. In the second place, the question may arise with respect to items which do constitute assets as to whether or not the taxpayer is the owner of those assets. And finally, the question

arises of whether or not an asset owned by a taxpayer consists of real or personal property (other than money) used by it in carrying on an insurance trade or business. With respect to whether or not a given item is an asset, it must be kept in mind that all insurance companies are required by Section 818 to maintain an accrual method of accounting and, therefore, definition of an asset must be pursuant to accrual methods of accounting. Thus, it is not material that, on the date of computation, the taxpayer must not have had a legally enforceable right to possession of the items in issue, or that nonpossession of the items in issue would deny to a taxpayer the right to invest the same. The question with respect to whether an asset exists must generally be whether under accrual principles of accounting the items in question must be included in computation of the taxpayer's assets.

4. Taxpayer argues that only such assets as may be available to it for investment are to be included in the Section 805(b)(4) definition of "assets." This Court concludes that taxpayer's contention is not well founded. *Western National Life Insurance Co. of Texas v. Commissioner, supra; Jefferson Standard Life Insurance Co. v. United States* [69-1 USTC ¶ 9278], 408 F. 2d 842 (C. A. 4, 1969), cert. denied, 396 U. S. 828 (1969); and *Franklin Life Insurance Co. v. United States* [68-2 USTC ¶ 9459], 399 F. 2d 757 (C. A. 7, 1968), cert. denied, 393 U. S. 1118 (1969). It is the application of

accrual principles of accounting made mandatory by Section 818(a) rather than any distinction between investable or noninvestable assets which control. To the extent that an insurance company is not required to recognize assets under accrual accounting principles because of the inchoateness of claims on accounts receivable, it must still treat each item consistently. That is, if a taxpayer *chooses* to accrue an item for one purpose (*e. g.*, maintenance of life insurance or other reserves), then it must accrue that item consistently for all purposes. In some cases this principle allows a taxpayer optional treatment, but should a taxpayer be allowed to accrue for any purpose and chose to do so, it must accrue for all without regard to possible tax consequences.

5. The next common issue in determining inclusion of assets is whether a given item is under such control of the taxpayer as to constitute an "asset of the company." Whether such control exists will normally be a question of fact, but it is not necessary that a taxpayer be a fee owner of an item in order for it to be classified as one of its assets. The questions to be decided generally with respect to this issue will be whether taxpayer can or does comingle an asset with other assets which it owns, whether it can or does utilize an asset in the conduct of its business, and whether it can or does invest that asset and, if so, whether the earnings from such investments can or do inure to the benefit of the taxpayer.

6. The final general issue to be considered by the Court in determining assets under Section 805 is whether or not an asset of the taxpayer consists of real or personal property (other than cash) used in its insurance trade or business. Treasury Regulations on Income Tax, Section 1.805-5(a)(4), define the only items to be excluded from the term "assets" as being considered to be used by the life insurance company in carrying on its insurance trade or business. These are as follows:

(a) The home and branch office buildings, including land;

(b) furniture and equipment used in those buildings;

(c) supplies, stationery, and printed matter used in the operations of the company; and

(d) automobiles and other depreciable personal property used in connection with the operations of the company.

7. Applying these principles to the asset issues, this Court concludes the following:

(a) The amounts representing debit balances from the new agents constituted an asset within the meaning of Section 805 as they are accounts receivable owned by the taxpayer and not utilized by it in its insurance trade or business. *Jefferson Standard Life Insurance Co. v. United States, supra*; *Franklin Life Insurance Co. v. United States, supra*; *Western National Life Insurance Co. of Texas v. Commissioner* [CCH

Dec. 28,954], 50 T. C. 285 (1968), modified, [CCH Dec. 29,463] 51 T. C. 824 (1969), rev'd on other issues, [70-2 USTC ¶9625] 432 F. 2d 298 (C. A. 5, 1970).

(b) Amounts recoverable from reinsurers constitute an asset of taxpayer under Section 805 as they are accounts receivable and not utilized in taxpayer's insurance trade or business. *Occidental Life Insurance Co. of California v. United States*, 70-1 USTC ¶9225 (C. D. Calif., Feb. 5, 1970), and *Western National Life Insurance Co. of Texas v. Commissioner, supra.* The amounts which represent taxpayer's share of FEGLI, Lincoln National Reinsurance Plan, and 65 health plans constitute assets of the taxpayer under Section 805. *Jefferson Standard Life Insurance Co. v. United States, supra; Franklin Life Insurance Co. v. United States, supra; Western National Life Insurance Co. of Texas v. Commissioner, supra.*

(c) To the extent that remittances and nonallocated items are duplications of assets already considered in taxpayer's computations, they are to be excluded from assets under Section 805; to the extent that they are not duplications of other assets, they are assets to be included under Section 805.

(d) Accident and health premiums due and unpaid are not includable in total assets under Section 805(b)(3).

(e) The amounts held by taxpayer and its mortgage servicing agents as mortgage escrow funds are not includable in total assets under Section 805(b)(3).

(f) Amounts held by taxpayer as trustee or agent are not includable in total assets under Section 805(b)(3).

(g) The intangible assets owned by taxpayer arising out of the transaction wherein it purchased the stock of the Atlantic Life Insurance Company, and which were amortized over a 10-year period, constitute an asset of the taxpayer in the amount of the unamortized portion. This capitalized portion of an asset of intangible but real nature is not utilized by taxpayer in the conduct of its insurance trade or business under Treasury Regulations, Section 1.805-5.

(h) The accrued unearned interest income on policy loans likewise constitutes an asset of taxpayer for Section 805(a) purposes. These items constitute accounts receivable of the taxpayer not used by it in the conduct of its insurance trade or business. *Jefferson Standard Life Insurance Co. v. United States, supra; Franklin Life Insurance Co. v. United States, supra.*

[*Interest Paid*]

8. The amounts paid as excess interest by taxpayer to qualified pension plans with regard to pension trust annuity contracts and pension trust life contracts do not involve life, health or accident contingencies. Section 805(e) provides that in determining the amount excluded for policyholders' share of investment income, all interest paid is to be taken into account, including amounts in the nature of interest which do not involve life, health or accident contingencies. The amounts paid in the nature of interest which

do involve life, health or accident contingencies are treated as dividends to policyholders under Section 812, but amounts paid in the nature of interest which do not involve life, health or accident contingencies at the time of accrual or payment are to be treated as interest as provided under Section 805(e)(2).

The amounts paid by taxpayer as excess interest to its pension plans constitute amounts in the nature of interest under Section 805(e)(2) and not dividends to policyholders. The reserves, when computed for the contracts in issue, do involve life, health and accident contingencies and, therefore, the reserves are life insurance reserves under Section 801(d).

[Deductions]

9. Taxpayer, in its exclusion of begining balances of nonparticipating contracts from the computations necessary to its special deduction under Section 809(b)(5), has no legal authority for its position. In computing the additions to reserves pursuant to the provisions of Treasury Regulations on Income Tax, Section 1.809-5(a)(5)(v), there is no provision for exclusion of beginning balances of nonparticipating contracts which become participating during the year. Only those adjustments allowed by Treasury Regulations, Section 1.809(d)(5)(A)(5)(iii), are allowable, and exclusion from beginning balances is not one of those adjustments. Nor in analogous situations is an out-calculation of beginning balances in computing additions to Section 801(b) reserves allowed. Thus, in computing additions to

reserves for phase II purposes, the taxpayer may not exclude the beginning reserves of those policies which mature by reason of termination or death during the year. Therefore, taxpayer's position with respect to exclusion of beginning balances on non-participating contracts is not well-founded. See *United Life & Accident Insurance Co. v. United States* [71-2 USTC ¶ 9620]. 329 F. Supp. 765 (N. H. 1971).

10. The Government has been well advised of taxpayer's claim on this issue, through both the claim for refund and conferences with its agents. Accordingly, the issue is properly before this Court and this Court has jurisdiction over the subject matter.

11. In computing its deduction for increase in reserves for non-participating contracts under Section 809(d)(5), for the year 1958, the entire amount of increase in reserve resulting from the strengthening required by the State of California in the amount of $820,068 is to be included and is not to be spread ratably over the next ten years as provided by Section 810(d).

[Remaining Issues]

12. Just as accrued but unearned interest income on policy loans must be included in computation of assets, it must be included in investment income, under Section 804(b). *Jefferson Standard Life Insurance Co. v. United States, supra; Franklin Life Insurance Co. v. United States, supra.*

13 The fact that taxpayer utilized a method of accounting for cost depletion other than the "sum of the dollars" method prior to January 1, 1964, and did not receive the permission of the Secretary of the Treasury or his delegate to change such such method precludes it from utilizing the "sum of the dollars" method for any payments received on oil payments purchased prior to January 1, 1964. The consent of the Secretary is absolutely necessary for taxpayer to change its method of accounting for cost depletion; this taxpayer neither requested nor received. Section 446; Rev. Rul. 65-10, 1965-1 Cum. Bull. 254.

14. In computing the allowable amount of bad debt loss incurred by taxpayer upon foreclosure of certain mortgages insured by the Federal Housing Administration or Veterans Administration, taxpayer must follow the procedure of Rev. Rul. 61-35, 1961-1 Cum. Bull. 48, which provides that the amount of bad debt loss realized on a defaulted insured loan is the difference between the adjusted tax basis of the loan and the fair market value of the FHA or VA debentures received in payment of the insurance obligation, and that the loss is realized at the time the debentures are received. This Revenue Ruling is in accord with generally recognized principles that measurement of bad debt loss is made following receipt of all recoveries, including those of guarantors, comakers, cosigners, and otherwise. It would distort taxpayer's income and deductions to allow it to take a gross

bad debt loss as ordinary income while reporting the fair market value of the debentures received from the FHA and VA as short-term capital gain which may be and was offset against long-term capital loss. Accordingly, Treasury Regulations on Income Tax, Section 1.166-6, may not be read for the provision that taxpayer's position on calculation of its allowable bad debts is well-founded. Secs. 1011 and 1016(a)(1). Taxpayer's reliance upon Treasury Regulations on Income Taxes, § 1.166-6, *Sale of mortgaged or pledged property*, is misplaced. Taxpayer reads subsection (b) of that Regulation as controlling in the measurement of the amount of allowable loss which would not take into account insurance recoveries. However, subsection (b) may be utilized only if the requirements of subsection (a) have been met and that section makes mandatory a showing by the taxpayer that "the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible * * *." Because a deficiency after a mortgage sale cannot be shown to be wholly or partially uncollectible while an insurance claim against the FHA or VA is still outstanding, plaintiff may not utilize the provisions of subsection (b). Of course, any deficiencies remaining may be deducted by plaintiff pursuant to subsection (b) as a Section 166 business loss.

15. Having filed its claim for refund, taxpayer may not add to or vary from the grounds set out therein if it is to prevail

in this action. *Real Estate Title Co. v. United States*, 309 U. S. 13 (1940); *Alabama By-Products Corp. v. Patterson* [58-2 USTC ¶9799], 258 F. 2d 892 (C. A. 5, 1958). Taxpayer's claim for refund, which is reflected in turn in its complaint, and the pretrial order set out those grounds which this Court has jurisdiction to consider. In its most succinct statement in the pretrial order (par. IV, par. 8), the issue is formulated as follows:

> Plaintiff contends that the excess price paid over the assets obtained is the cost of acquiring life insurance which is deductible in the year incurred * * *.

16. It is axiomatic that the taxpayer in a federal tax refund action must plead and prove its case. The burden is on the taxpayer to show that a deduction it claims, for example, is clearly within the language and intent of the taxing statute. *United States v. Olympic Radio & Television* [55-1 USTC ¶9459], 349 U. S. 232 (1955); *White v. United States* [38-2 USTC ¶9600], 305 U. S. 281 (1938). They are made with respect to the applicability of Treasury Regulations on Income Tax, § 1.817-4(d)(2) and (3) (26 C. F. R.), which bear upon the tax treatment of reinsurance transactions. The taxpayer has taken the basic position that there is no writ in the statute for the promulgation of those regulatory sections, and, therefore, the Government was in error in denying the claimed immediate deduction for the bonus. The law, however, puts the burden squarely on the plaintiff here to cite a section of the

Internal Revenue Code and to show that its transaction falls within the purview of that section. This, taxpayer has not done.

17. Treasury Regulations to Section 817, cited above, set out the rules with respect to acquisition of blocks of insurance. These rules indicate that taxpayer's transaction falls with Example (2) of Section 1.817-4 (d)(3). Inasmuch as that regulation denies immediate deduction of bonuses and requires amortization of such bonuses over the useful life of the contracts, this Court concludes that the only statutory or regulatory authority to which it has been cited is against the taxpayer.

18. This Court concludes that the decision in *Mutual Savings Life Insurance Co. v. United States* [74-1 USTC ¶9208], 488 F. 2d 1142 (C. A. 5, 1974), construing those regulations, controls the issue as framed by taxpayer's claims and the pretrial order. In *Mutual Savings* the court examined the tax consequences of one life insurance company acquiring a block of policies from another in a reinsurance transaction. The court stated first the general rules applying to both the reinsured (here, Atlantic) and the reinsurer (here, taxpayer) companies. These rules provide that the reinsurer, upon acquiring the policies, must increase its reserves, which increase in reserves is treated as an immediate tax deduction. Any consideration received in the transaction, however, must be immediately reported as income. Finally, at page 1144, the Fifth Circuit considered the proper treatment by

the reinsurer upon the payment of additional consideration:

> But if the reinsurer has paid consideration for the policies, the payment cannot immediately be deducted, but must be amortized over the estimated life of the contracts.

19. This Court concludes that the reinsurance transaction here is analogous to the *Florida Life* transaction considered by the Fifth Circuit in *Mutual Savings*. There, the taxpayer's consideration consisted of two items: Assumption of reserve liabilities and payment of a cash bonus. There were no assets transferred to it in connection with the policies which would have resulted in a taxable income. (Here, the consideration paid by the taxpayer also falls into two categories: Assumption of reserve requirements and other liabilities and the payment of the $29 million bonus.) The Court held that the taxpayer was entitled to the deduction for the addition to reserves portion of the consideration paid under Section 809(d)(7), but required the amortization of the bonus paid. Here, the result ought to be no different. Taxpayer is entitled to a deduction for the reserves assumed (which has already been allowed by the Government), but must amortize the portion of the cash bonus paid over and above the fair market value of assets received.

20. The latest position of the taxpayer, as related in its brief, constitutes a variance from the issue as framed in paragraph 14 above, and as determined by the Fifth Circuit in *Mutual Savings*. For that reason

alone, this Court does not have jurisdiction to consider new grounds relied upon now by the taxpayer. *Real Estate Title Co. v. United States, supra*. Nevertheless, this Court concludes that the position of the taxpayer advanced in its brief, even if independently examined, would not support a judgment.

21. Taxpayer's present argument is that some part of the bonus it paid for the Atlantic Life Company should be attributed to its stock rather than to the block acquisition of insurance. There are two formidable obstacles to this argument to be overcome. The first of these is the general proposition that acquisition of or investment in a business is a capital expenditure which may not be currently deducted or even amortized over a period of time. *Higgins v. Commissioner* [41-1 USTC ¶ 9233], 312 U. S. 212 (1941); *Woodward v. Commissioner* [70-1 USTC ¶ 9348], 397 U. S. 572 (1970).

22. Taxpayer's major point, however, appears to be directed at splitting the $29 million in cash consideration paid by it into separate elements applicable to the reinsurance of Atlantic's contracts and the purchase of Atlantic's stock. The purpose of this appears to be to reduce the assets received in the amount of $118,798,778 by a figure of more than $30 million through ascribing some of those assets to stock rather than as listed on joint Exhibit 38. If this is taxpayer's position, it is directly contrary to the provisions of Section 334(b)(2). In examining that section, it should be realized that taxpayer's acquisition of the

Atlantic stock was pursuant to a plan under Sections 332 and 334 of the Code.

23. Section 334(b)(2) is a codification of the Fifth Circuit's decision in *Kimbell-Diamond Milling Co. v. Commissioner* [CCH Dec. 17,454], 14 T. C. 74 (1950), aff'd *per curiam*, [51-1 USTC ¶9201] 187 F. 2d 718 (C. A. 5, 1951), cert. denied, 342 U. S. 827 (1951). The thrust of Section 334(b)(2) is to ignore the purchase of corporate stock where the purchasing corporation liquidates the acquired corporation within two years of acquisition (as was done here). Section 334(b)(2) treats such a transaction as if the purchasing corporation acquired the assets of the acquired corporation rather than its stock. See 3A Mertens, *Law of Federal Income Taxation*, par. 21.167, pp. 475-482.

24. Here the taxpayer conformed to the requirements of Section 334 in all respects. It allocated the entire purchase price ($128,662,909.97) among the fair market value of the various assets received, including the intangible "insurance in force." To attempt now to reallocate the purchase price in a manner other than required by the statute is not supportable.

25. Nor is there any true distinction between the Fifth Circuit's decision in *Mutual Savings* and the present case on the basis that in *Mutual Savings* there was a straight acquisition of a block of insurance, whereas here there was acquisition of the company holding the block of insurance. Section 332 (b)(2) and the *Kimbell-Diamond* doctrine strike through any such distinction.

26. Nor do taxpayer's points with respect to industry practices, accounting, or Congressional intent convince the Court to ignore the principles set forth above. The first of taxpayer's points may be met with the simple statement that insurance industry practices do not control this Court; rather, the Internal Revenue Code is the applicable law. To the extent that insurance industry practices are not in accord with the Code, they must be ignored. *Western National Life Ins. Co. of Texas v. Commissioner* [70-2 USTC ¶9625], 432 F. 2d 298 (C. A. 5, 1970).

27. Secondly, accrual accounting principles provide for the matching of revenues and expenses with each other without regard to the actual time of receipt or expenditure of cash. *United States v. Anderson* [1 USTC ¶155], 269 U. S. 422 (1926). Accordingly, under the matching principles of accrual accounting, the cost of acquisition of insurance policies must be amortized over the useful life of those policies.

28. Finally, taxpayer's citation to S. Rep. No. 291, 86th Cong., 1st Sess. (1959-2 Cum. Bull. 770, 776, 784), gives no support to its claimed treatment of block assumption of insurance contracts or the acquisition of one life insurance company by the other.

29. It follows that because taxpayer may not deduct the bonus in the year of payment, the unamortized portion of the bonus must be dealt with for the purposes of

Section 805(b)(4). That section defines "assets" for the purposes of inclusion in the Phase I Computation of an insurance company's tax liability. That section and the Treasury Regulations thereunder define assets in an all inclusive manner with certain stated exceptions. This Court concludes that the unamortized portion of the bonus paid for acquisition of the Atlantic Life policies constitutes such an asset which is reflected (as it must be) on the books of taxpayer.

30. This Court further concludes that Treasury Regulations on Income Tax, § 1.805-5(a)(4), do not, in the listed exceptions, include such an asset as the unamortized portion of the bonus paid. Certainly, the unamortized portion of the bonus does not fit within the exception of Treasury Regulations on Income Tax, § 1.805-5(a)(4)-(i)(d), "automobiles and other depreciable personal property used in connection with the operations conducted in the home office * * *."

31. Accordingly, this Court concludes that the bonus paid must be amortized over the useful life of the policies (10 years) and the unamortized portion of the bonus must be included in "assets" under Section 805.

32. Any finding of fact deemed as properly constituting a conclusion of law is hereby adopted as a conclusion of law.

The parties will draw a judgment in conformity with these findings of fact and conclusions of law.

APPENDIX C

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 75-2675

SOUTHWESTERN LIFE INSURANCE COMPANY,
Plaintiff-Appellee,
Cross-Appellant,

versus

UNITED STATES OF AMERICA,
Defendant-Appellant,
Cross-Appellee.

Appeal from the United States District Court for the Northern District of Texas

ON PETITION FOR REHEARING

(December 2, 1977)

Before TUTTLE, GOLDBERG and CLARK, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ EDWARD W. WADSWORTH
United States Circuit Judge

Supreme Court, U. S.
FILED
MAR 31 1978
MICHAEL RODAK, JR., CLERK

No. 77-1124

In the Supreme Court of the United States

OCTOBER TERM, 1977

SOUTHWESTERN LIFE INSURANCE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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v.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. B, pp. B-1 to B-54) is not officially reported. The opinion of the court of appeals (Pet. App. A, pp. A-1 to A-53) is reported at 560 F. 2d 627.

JURISDICTION

The judgment of the court of appeals was entered on October 5, 1977. A petition for rehearing filed by petitioner was denied on December 2, 1977. The petition for a writ of certiorari was filed on February 10, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals correctly held that payments made by petitioner with respect to insurance contracts it issued to various pension and profit-sharing plans, and characterized by it as "excess interest," did not qualify as "amounts in the nature of interest" within the meaning of Section 805(e)(2) of the Internal Revenue Code of 1954.

Section 805(e)(2) of the Internal Revenue Code of 1954 (26 U.S.C.) provides:

> SECTION 805 [as amended by Section 2(a), Life Insurance Company Income Tax Act of 1959, 73 Stat. 120]. POLICY AND OTHER CONTRACT LIABILITY REQUIREMENTS.
>
> * * * * *
>
> (e) *Interest Paid.*—For purposes of this part, the interest paid for any taxable year is the sum of—
>
> * * * * *
>
> (2) *Amounts in the nature of interest.*—All amounts in the nature of interest, whether or not guaranteed, for the taxable year on insurance or annuity contracts (including contracts supplementary thereto) which do not involve, at the time of accrual, life, health, or accident contingencies.
>
> * * * * *

STATEMENT

Petitioner is a life insurance company which issues various types of insurance contracts, including certain specialized annuity and life insurance contracts designed for pension and profit-sharing plans. The pension trust

annuity contracts generally provided for specified monthly payments upon a participant's retirement or attainment of age 65, and for payment of death benefits prior to such time in the amount of the cash surrender value of the policy. The pension trust life contracts provided for the payment of specified additional death benefits to plan participants. Petitioner maintains life insurance reserves with respect to both types of contracts (Pet. App. A, pp. A-25 to A-26).

Under state law, the maximum interest rate petitioner could use in computing these reserves is 3 1/2 percent. In order to compete more effectively with banks and other financial institutions that administer pension plans, petitioner agreed to pay the plans that purchased its contracts an annual amount, which it characterized as "excess interest." Petitioner agreed to pay this additional amount when its actual earnings rate exceeded the 3 1/2 percent assumed interest rate used in computing the reserves. The amount of this "excess interest" is computed on the basis of a "new money rate" formula which reflects petitioner's return (with certain adjustments) on funds invested by it during the year (Pet. App. A, pp. A-25 to A-26).

On its income tax returns for the years in issue, petitioner treated its "excess interest" payments as "amounts in the nature of interest" under Section 805(e)(2) of the Code, which had the effect of increasing the portion of its net investment income excluded from its "taxable investment income" under Section 804(a)(1) as the "policyholders' share" of such income. On audit, the Commissioner determined that petitioner's "excess interest" payments did not qualify as amounts in the nature of interest as that term is defined in Section 805(e)(2). The Commissioner's position rested on the fact that the

contracts in question involved life contingencies and Section 805(e)(2) applies only to payments with respect to contracts "which do not involve, at the time of accrual, life, health, or accident contingencies" (Pet. App. B, p. B-19).[1]

In this refund suit in the United States District Court for the Northern District of Texas, the court held that petitioner's "excess interest" payments were "amounts in the nature of interest" under Section 805(e)(2). In that court's view, all that was required for a payment to qualify under Section 805(e)(2) is that the "amounts" of such payments "do not involve, at the time of accrual, life, health, or accident contingencies," without regard to whether the contracts themselves involve such contingencies (Pet. App. B, pp. B-43 to B-44).

The court of appeals reversed. It concluded that the statutory phrase "which do not involve, at the time of accrual, life, health, or accident contingencies" refers to the term "contracts" and not the term "amounts." Since there was no dispute that the contracts in question were subject to such contingencies, the court of appeals held that the excess interest payments failed to qualify as "amounts in the nature of interest" under Section 805(e)(2) (Pet. App. A, pp. A-25 to A-31).

ARGUMENT

1. In this life insurance company income tax case of first impression, the court of appeals correctly held that petitioner's payments of amounts characterized as "excess

[1]The Commissioner allowed the "excess interest" payments to be treated as "dividends to policyholders," deductible in the computation of petitioner's "gain from operations" under Section 809(d)(3), subject to the limitations provided by Section 809(f).

interest" did not qualify as "amounts in the nature of interest" under Section 805(e)(2) of the Code. As a result, petitioner could not take these payments into account in computing the exclusion for the "policyholders' share" of its net investment income. See Section 804.

Section 805(e) defines "interest paid" by a life insurance company as the sum of four elements, including "amounts in the nature of interest" (Section 805(e)(2)). The statute defines that term as "[a]ll amounts in the nature of interest, * * * on insurance or annuity contracts * * * *which do not involve, at the time of accrual, life, health, or accident contingencies*" (emphasis supplied).

Petitioner did not dispute in the courts below that the annuity and life contracts it issued to the pension plans involved "life, health, or accident contingencies." However, it argued that the final statutory phrase—"which do not involve, at the time of accrual, life, health, or accident contingencies"—modified the word "amounts" and not the term "insurance or annuity contracts," as the government urged.

But as the court of appeals pointed out (Pet. App. A, pp. A-30 to A-31), petitioner's construction of the statute—"all amounts * * * which do not involve * * * contingencies"—makes little sense, since an "amount" cannot "involve, at the time of accrual, life, health, or accident contingencies." As the court observed, for petitioner's construction to have any meaning, the statute would have to read as "all amounts whose computation does not * * * [etc.]." That is not what Congress said, however, and there is no basis for petitioner's gloss upon the statute.

On the other hand, the government's reading of the statute "has a complete meaning as written" (Pet. App. A, p. A-30), *viz.*, "[a]ll amounts in the nature of interest

* * * on insurance or annuity contracts * * * which do not involve, at the time of accrual, * * * contingencies." Since petitioner did not dispute that its annuity contracts involved such contingencies, the court of appeals properly concluded that petitioner's "excess interest" payments did not qualify under Section 805(e)(2).[2]

Moreover, the concept of contracts which do or do not involve life or accident contingencies is a familiar one in life insurance company taxation. For example, Section 801(b)(1)(B) defines the term life insurance reserves as "amounts * * * which are set aside to mature or liquidate, * * * future unaccrued claims arising from life insurance, annuity, and noncancellable health and accident insurance contracts * * * *involving* * * * *life, health, or accident contingencies*" (emphasis supplied). There is no doubt that the final phrase in Section 801(b) modifies the word "contracts" and not "amounts." See Treasury Regulations on Income Tax, Section 1.801-4(d) and (e) (26 C.F.R.).

Finally, the distinction drawn by Section 805(e)(2) between amounts in the nature of interest on contracts that involve contingencies and such amounts on contracts that do not is consistent with the statutory scheme of life insurance taxation. With respect to contracts that involve life contingencies, the reserves will qualify as "life insurance reserves" and the company's earnings from its reserves will be taken into account in determining the exclusion of the policyholders' share of the company's investment yield under Section 805(a)(1) or (a)(2). Thus, as the court of appeals correctly recognized (Pet. App. A,

[2]Section 805(e)(2) was first enacted into law in the Revenue Act of 1942 as Section 201(c)(6)(B) of the 1939 Code. Although the Committee Reports do not address the specific question at issue here, the Senate Report indicates that the phrase under consideration refers to "contracts" and not to "amounts." S. Rep. No. 1631, 77th Cong., 2d Sess. 146 (1942). See also Nash, *Federal Taxation of Life Insurance Companies*, Vol. 1, §6.04[2], p. 6-37 (1977).

pp. A-30 to A-31), petitioner's construction of Section 805(e)(2), under which its "excess interest" payments would be taken into account in determining the policyholders' share of investment income, would result in a double exclusion for all or a substantial portion of its earnings on its pension plan reserves.

Under Section 805(a)(2), petitioner is entitled to exclude its current earnings on its pension plan reserves. The "excess interest" payments for which petitioner seeks an exclusion under Section 805(a)(3) are also based on its earnings on its pension plan reserves. Since its earnings on such reserves already have been excluded from taxation under Section 805(a)(2), the court of appeals properly refused to permit petitioner to exclude them a second time under Section 805(a)(3).[3] See also Section 818(e).

2. Petitioner alternatively argues (Pet. 25-27) that even assuming the correctness of the court of appeals' interpretation of Section 805(e)(2), its "excess interest" payments qualify under the statute because its contracts did not involve life or accident contingencies at the time it accrued the payments. The annuity contracts involved life contingencies from their inception and not merely at their maturity date. Indeed, petitioner's own actuary so testified in the district court (R. 250-251).[4]

[3]The exclusion for pension plan earnings provided in Section 805(a)(2) is limited to the "current earnings rate." Thus, the exclusion would not encompass petitioner's excess interest payments to the extent those payments were based on a "new money rate" in excess of "current earnings rate." Nevertheless, as petitioner concedes (Pet. 18-19), adoption of its position would in all events result in a double exclusion for a substantial portion of its pension plan reserves, and when the company's "current earnings rate" approached the "new money rate," there would be a double exclusion of the entire amount of its excess interest payments.

[4]"R." refers to the record appendix filed in the court of appeals.

Moreover, if petitioner's annuity contracts are not considered as involving such contingencies prior to maturity, it would follow that the reserves on such policies would not qualify as "life insurance reserves" under Section 801(b). The fact that a participant might withdraw the cash surrender value before payment of the annuity benefit begins provides no more basis for holding that payments under such contracts prior to that time are "amounts in the nature of interest" under Section 805(e)(2), than it would for holding that the reserves for such contracts are not "life insurance reserves" under Section 801(b).[5]

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[5]Finally, petitioner complains (Pet. 14-18) that the decision below puts life insurance companies at a competitive disadvantage with respect to banks and other financial institutions which administer pension trusts. But it can hardly be seriously claimed that insurance companies are unfairly taxed in relation to such other types of financial institutions. Indeed, Congress permits a life insurance company to exclude the entire amount of its current earnings on its pension plan reserves from taxation, even though only a part of those earnings might actually "belong" to the policyholders.

Petitioner also suggests (Pet. 17-18, 26-27) that certiorari should be granted in order to stem the "substantial litigation" it suggests this decision will provoke. But the question presented in this case is of first impression. Despite in fact that the 1959 Act has now been in effect for almost 20 years, this is the only decided case on this point.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH 1978.